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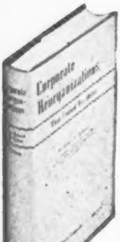

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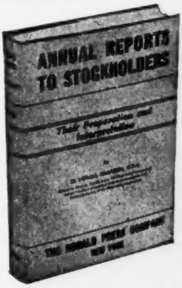


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## An Accounting System for a Farm

*By* RICHARD H. SMITH, C.P.A.

THE average operator of a small farm, if queried, would probably reply that he had no accounting system and had no intention of ever having one. He would probably tell you that any good farmer doesn't need any figures (except the size of his bank balance) to see how things are going. If pressed, he would probably admit that he does have a book that shows what cash he takes in, what cash he spends and what he spends it for—and that the only reason he keeps that is so someone can tell him how much income tax he has to pay. He might concede that big farms need books and records and reports; but not his. He may be right.

As the farm increases in size and complexity, conditions which are present on the small farm will be accentuated. Farming operations, widely different in nature and cost, may be carried on, products may be sold or used, products may be carried over from one crop year to another, a substantial investment in farm buildings and machinery may be required, etc. Accounting "in the farmer's head" is then difficult if not impossible and it becomes necessary to introduce a method whereby the financial information is recorded, classified and summarized in a manner which will provide management with important and reliable information. For this, cash records alone will not suffice.


RICHARD H. SMITH, C.P.A., the author of this article, is a supervisor in the system department of Price, Waterhouse & Co. He is a Certified Public Accountant of New York State and a member of the American Institute of Accountants. He has the degree of Bachelor of Accounting from the University of Saskatchewan and is a member of the Institute of Chartered Accountants of Saskatchewan.


It would appear that the farm accounting system should be based on (1) the distribution of expenses by departments or operations, (2) the accrual of unpaid expenses at the end of each accounting period, (3) a system of perpetual inventory records supplemented by periodic physical inventories, and (4) the determination of product costs. Such an accounting system will provide the farmer with costs and profits by products so that he can direct his greatest efforts to profitable lines and eliminate losses by adopting more economical methods of production. The system should be designed in such a manner that taxable income can be determined on a cash or accrual basis, whichever is more favorable to the owner, and should lend itself to the introduction of budgets if such control is desired.

### Description of Business

The farm for which an accounting system will be described would comprise approximately 2,000 acres of land and suitable buildings and equipment, including residences. The operations would include (1) the cultivation of approximately 50% of the land for the purpose of raising wheat, oats, barley, corn, alfalfa and hay, both for sale and

for feed; (2) the maintenance of a large herd of purebred dairy cattle and the marketing of the milk produced; (3) the raising of calves principally for replacement of the dairy herd; (4) the maintenance of adequate pasturage for the livestock; (5) the raising of a large flock of chickens and the marketing of broilers and eggs; and (6) the maintenance of a small orchard and garden.

It will be assumed that the farm is operated by the owner who lives on the farm and that he employs approximately 35 men including a bookkeeper. It will also be assumed that the operating expenses of the owner's residence are included in the farm accounts and that adequate safeguards are provided to assure a proper segregation of such personal expenses from those pertaining to farming operations.

In most areas of this country the majority of farm crops are planted, harvested and sold within the calendar year. Livestock, poultry, orchard and garden operations are also most active during the spring, summer and fall months. It would appear, therefore, that the calendar year serves admirably as a fiscal year, and, unless there are special reasons for selecting another, it should be used.

## Chart of Accounts

The selection and arrangement of the accounts in which the farm transactions are to be recorded is of considerable importance. All account titles should describe accurately the transactions recorded therein and, in so far as possible, each account should include only one type of transaction, such as direct labor or depreciation. The accounts should be coded in such a way that identification will be easy in order to eliminate the necessity for writing account titles on invoices and other original records, and they should be arranged in the order in which they will appear in the financial statements. The general plan of coding should provide ample flexibility for additional accounts and departments which may be required in future operations.

The chart of accounts presented below provides the accounts necessary for the farm described above.

---

*Balance Sheet Accounts:*

Cash—(1000-1099):
- 1001 Imprest cash fund
- 1002 Cash on hand
- 1010 Cash in bank
- 1090 Cash sales—clearing account

Notes and accounts receivable—(1100-1199):
- 1101 Accounts receivable
- 1110 Notes receivable
- 1120 Loans receivable—employees
- 1199 Reserve for bad debts

Inventories—(1200-1299):
- 1201 Farm products
- 1210 Cost of growing crops
- 1250 Feed
- 1260 Fertilizer
- 1270 Other operating supplies

Fixed assets—(1500-1590):
- 1501 Land
- 1510 Buildings
- 1520 Implements and tools
- 1530 Autos and trucks
- 1540 Orchard
- 1550 Dairy herd
- 1555 Calf herd
- 1590 Construction in progress

Reserves for depreciation of fixed assets—(1600-1690):
- 1610 Reserve for dep'n—buildings
- 1620 do —implements and tools
- 1630 do —autos and trucks
- 1640 do —orchard
- 1650 do —dairy herd

Prepaid expenses—(1900-1999):
- 1901 Unexpired insurance
- 1910 Prepaid taxes
- 1920 Repair and expense supplies
- 1930 Deferred calf costs
- 1940 Deferred development costs

Current liabilities—(2000-2099):
- 2000 Notes payable
- 2001 Accounts payable
- 2010 Accrued salaries and wages
- 2020 Accrued real estate taxes
- 2030 Accrued interest
- 2090 Other current and accrued liabilities

Mortgage debt—(2100-2199):
- 2101 Mortgage payable

Proprietorship—(2800-2899):
- 2800 Owner's investment
- 2850 Current profit and loss
- 2890 Owner's personal account

*Profit and Loss Accounts:*

Sales—(3000-3099):

3001 Milk Sales
3005 Calf sales
3010 Grain and hay sales
3020 Poultry sales
3021 Egg sales
3030 Sales of fruit and vegetables

Cost of sales—(3500-3599):

3501 Cost of dairy operations
3505 Cost of calves sold
3510 Cost of current farming operations
3511 Cost of farm products sold (prior year's production)
3520 Cost of poultry operations
3530 Cost of orchard and garden operations

Administrative expense—(4000-4099):

4001 Salaries
4005 Stationery and supplies
4010 Maintenance and repairs
4015 Taxes and licenses
4020 Insurance
4025 Depreciation—buildings and equipment
4030 Fuel
4035 Electricity
4040 Water
4045 Telephone and telegraph
4050 Automobile expenses
4055 Traveling expenses
4060 Entertainment expenses
4061 Donations
4062 Subscriptions and dues
4063 Legal and audit
4064 Bad debts expense
4065 Advertising
4099 Other miscellaneous expenses

Other income and charges (4500-4599):

4501 Profit or loss on disposal of capital assets
4510 Interest expense
4590 Miscellaneous income and charges

*Operating Cost Accounts:*

In the case of operating costs, the first and second digits of the account code will identify, respectively, the general type of operation and nature of the operation. The third and fourth digits will identify the expense classifications.

The departments or operations are as follows:

Livestock operations—(5000-5999):

5100 Dairy herd
5200 Calf herd

Farming operations—(6000-6999):

6100 Field crops
6200 Poultry
6300 Orchard and garden

Service operations—(9000-9999):

9100 Water plant and distribution system
9200 Machine shop
9300 Maintenance of roads and fences
9400 Employees' housing and board
9900 Owner's residence and personal expenses

The expense classifications, all of which are applicable to one or more of the above operations, are as follows:

01 Labor—paid in cash
02 Labor—paid in produce
11 Seed
12 Fertilizer
13 Feed
14 Baby chicks purchased
15 Operating supplies
21 Farm implement expenses
22 Truck and car expenses
23 Building maintenance and repairs
24 Road and fence maintenance costs shared
31 Taxes and licenses
32 Insurance—buildings and equipment
33 Insurance—livestock
34 Insurance—crops
35 Insurance—workmen's compensation
36 Fuel
37 Electricity
38 Water cost shared
39 Telephone
41 Depreciation—buildings and equipment
42 Depreciation—livestock
45 Amortization—development costs
51 Veterinary
52 Registration fees
53 Transfer fees
54 Testing expense
55 Death and accident loss
61 Farm products supplied
62 Food purchased
63 Expenses paid for owner
80 Inventory adjustment account
81 Other miscellaneous expenses
91 Costs applicable to dry dairy cows
92 Calf costs capitalized
96 Costs of crops produced
97 Cost of development—deferred
99 Cost of operations—clearing account

## Accounting Records

A brief description of the more important accounting records follows.

*Cash Receipts Book:*

The cash receipts book should provide columns for date, name, amount received, cash sales, accounts receivable, general ledger account number and amount (for items to be posted individually to general ledger accounts), and bank deposits. Monthly totals would be posted to the general ledger direct from the cash receipts book.

*Invoice Register:*

The invoice register should be a loose-leaf record with columns for invoice number, date, name, description, the amount of the invoice or bill, date paid, check number, and several distribution columns, each including space for the number of the account to be charged and the amount. The distribution columns would be used for such items as supplies purchased for inventory, purchases of capital assets, administrative expenses, departmental operating costs and other accounts.

The distribution columns of the voucher register would be analyzed at the end of each month and postings would be made direct to the general ledger.

*Check Register:*

To avoid the necessity of writing up a cash disbursements book, a carbon copy of the check and pay statement should be filed numerically and used as the check register. A journal entry would be prepared at the end of each month recording the total of checks issued, debiting accounts payable and crediting cash in bank.

*Sales Register:*

The sales register should be a loose-leaf record with columns for date, invoice number, name, description, amount of sale (divided as to charge and cash sales), distribution columns for each of the sales accounts and a sundry account column for sales of capital assets, expense supplies, etc. Postings to the general ledger would be made from the sales register.

*Daily Reports:*

The foremen of the various farm departments or operations should submit to the bookkeeper daily reports of feed, seed, fertilizer and supplies used; production of milk, eggs, and other items; calves born of dairy cows; and any other information necessary to the proper recording of the day to day farming operations. A sample of a daily report of dairy operations is presented as Form 1.

The bookkeeper should summarize the daily reports of production, consumption, etc., of the various departments or operations and prepare the monthly journal entries recording the transactions.

*Payroll Records:*

The payroll records should consist of daily or weekly time reports, a payroll journal and employees' individual compensation records. The time reports should reflect the nature of the work done by each employee and the departments or operations to be charged for the labor cost. The time reports of employees engaged in crop farming should reflect the hours chargeable to each field or crop as well as the nature of the work such as seeding, cultivating, harvesting, etc. The time reports would be used as the basis for (1) determining employees' earnings, (2) determining the account distribution of the labor cost, and (3) developing statistical information as to operation and crop costs.

*Dairy Cattle Record:*

A dairy cattle record sheet (Form 2) should be maintained for each of the pure-bred cows and bulls in the dairy herd. The information to be recorded on this form is as follows:

Registration and tattoo numbers
Name of the animal
Its parentage and breed
The date it was purchased or transferred to the dairy herd from the calf herd
Its cost whether purchased or raised
The annual depreciation provided and the depreciation accumulated to date
A record of the operating costs applicable to the cow during the months it produces no milk (This cost will become the initial cost of the calf born of the cow)
A record of the calves born of the cow
The name of the purchaser, the sale price and the reason for selling the animal

*Calf and Heifer Record:*

A calf and heifer record (Form 3) should be maintained for each calf born of a dairy cow or purchased for dairy herd replacement. This form provides space for the following information:

Registration and tattoo numbers
Name of the animal
Its parentage and breed
The dates it was (1) born or purchased, or both, and (2) sold, died or transferred to the dairy herd
The cost to raise the calf to maturity
The name of the purchaser, the sale price and the reason for selling the animal

*Property Record:*

An asset and depreciation record should be maintained for each fixed asset item. This record should provide spaces for recording the following information:

Description of item
Classification
Department in which it is used
Date acquired
Estimated life and the depreciation rate
Cost
Annual depreciation provision and the accumulated depreciation at the end of each year

*Journal Vouchers:*

Journal vouchers should be used for all accounting entries other than those posted to the general ledger from the cash receipts book, the invoice register and the sales register. The voucher should provide spaces for account numbers and names, debit and credit amounts, a description of the entry, the date and the journal voucher number.

*Work Orders:*

The maintenance and repair work done in the machine shop should be recorded on work orders in order that the accounts of the operation for which the work was done may be charged. The information recorded on each work order by the foreman of the mechanic shop would include a brief description of the work, the department or operation for which it was done, a list of the materials used and the names and hours of the employees that did the work. Each work order should be signed by the employee responsible for carrying out the work and by the foreman of the department for which the work was done. The bookkeeper would determine the cost of the materials and labor on all work orders and distribute the overhead expenses of the service department to the various orders on the basis of total labor and material cost.

## Accounting Procedures

The size of the farm organization usually will not permit the segregation of duties of employees to the extent that complete internal accounting control is possible. It is desirable, therefore, that all employees be bonded and that all procedures established for the reporting and approving of accounting transactions be strictly adhered to.

A description of the more important accounting procedures, particularly those not self-evident from the chart of accounts and the description of accounting records used, follows:

*Purchasing:*

Purchase requisitions should be prepared by farm employees and approved by the department foremen before being presented to the bookkeeper who should issue all purchase orders. In addition to the copy of the purchase order retained by the bookkeeper, a copy which does not show the quantity ordered should be given to the department foremen for use as a receiving report when the materials or services are received.

*Recording and Payment of Vendors' Invoices:*

All vendors' invoices should be checked to the office copies of the purchase orders and the receiving copies of the purchase orders should be attached to the invoices. All invoices should be entered in the invoice register and charged to the accounts and departments indicated on the purchase orders. After payment the date and number of the check should be entered in the invoice register opposite the items paid so that a trial balance of accounts payable may be prepared therefrom at the end of each month. Bills for utilities and services that are not covered by purchase orders should be approved by the owner or the farm superintendent prior to entry and payment.

When invoices are due for payment the bookkeeper should prepare an original and one copy of the check with pay statement attached. The invoices, checks and pay statements should be presented to the owner who should sign the checks and approve the payments by signing the duplicate copies of the pay statements. If possible the owner or another employee should mail the checks and original pay statements, and stamp the invoices "paid" prior to the return of the duplicate pay statements and paid invoices to the bookkeeper for filing. The duplicate copies of the pay statements should be filed in check number sequence and used as the check register. If desirable a third copy of the pay statement could be prepared and filed alphabetically as a record of payments made to the various vendors.

*Inventory Records and Controls:*

Perpetual inventory records should be maintained for feed, supplies and other items of which relatively large quantities are carried on hand. The daily reports of quantities consumed submitted by the department foremen should be priced and extended by the bookkeeper and entered in the inventory records. The daily reports should be coded for the accounts to be charged and, at the end of each month, a summary thereof should be recorded by journal entry charging operating cost accounts and crediting the inventory control accounts. Physical inventories of these items should be taken periodically and the book balances adjusted accordingly.

*Sales:*

All sales of farm products should be recorded on sales invoices which should be entered in the sales register. However, if milk is sold in bulk to a dairy, the agreement may provide for payment on the basis of butterfat content as shown by tests made at the dairy. In this case it may be practicable to make the entry in the sales register from the dairy's monthly statement after the quantities shown on the statement have been checked to the quantity sales summarized from the daily reports of dairy operations.

*Costs of Operations:*

The cost of production of each of the farm enterprises or operations would be obtained from the operating cost accounts. The costs of service operations (except the owner's residence and personal expenses) would be distributed to productive operations on appropriate bases in order to determine total production costs. Although the books

should be closed monthly and certain operations are seasonal, such as crop farming, the costs of production should be determined on an annual basis since each operation should be charged for taxes, insurance, depreciation and other fixed overhead costs for a full year.

The procedures covering the allocation of total operating costs for each of the productive and service departments or operations are as follows:

1. Dairy herd:

The monthly cost of operations for the dairy herd should be apportioned on the basis of the daily average numbers of cows that are milked and cows that are dry. The amount applicable to milking cows would represent the cost of milk produced whereas the amount applicable to dry cows would be the initial cost of calves that will be borne of these cows. The amount applicable to dry cows should be deferred until the calves are born when it should be capitalized. The journal entries recording the monthly allocation of dairy herd operating costs may be summarized as follows:

Debit:
Acct. No. 1930 Deferred calf costs
3501 Cost of dairy operations
5102 Labor—paid in produce
5213 Calf feed
Credit:
Acct. No. 5191 Costs applicable to dry cows
5199 Cost of operations—clearing account

The amount charged to account 1930, deferred calf costs, should be allocated to the dry cows in proportion to the number of days each was dry during the month, and the amount applicable to each would be recorded on the related dairy cattle record. When the cow drops the calf it was carrying during its dry period, the amount accumulated on the dairy cattle record should be transferred to the calf and heifer record set up for the new calf.

After deducting the costs of the dairy operation which are allocated to dry cows, the remaining operation costs would be the cost of milk produced. If there was any milk on hand at the close of business on the last day of the month, an adjusting entry would have been made charging inventory of farm products and crediting inventory adjustment account (account number 5180). This entry would be reversed in the following month.

The quantities of milk fed to calves and given to dairy employees would be extended at the previous month's unit cost of production and charged to the applicable expense accounts. The remaining costs would be the cost of milk sold.

2. Calf herd:

The total cost of the calf operation would represent the cost of raising calves. This cost should be capitalized monthly on a unit basis. The cost applicable to each calf should be computed after due consideration of the number of days from birth until the end of the month for new-born calves, and of the number of days from the first of the month to (1) date of sale, (2) date of death, and (3) date of transfer to the dairy herd, for calves (and heifers) no longer on hand at the end of the month. The amount applicable to each calf should be posted on each calf and heifer record and accumulated until the calf reaches maturity. At maturity, when the calf is transferred to the dairy herd, its cost would be transferred to the dairy cattle record set up for it, after the necessary book entry has been made.

When calves die or are sold, the cost would be obtained from the calf and heifer records of such calves and recorded by journal entry charging account 5255 for the death losses and account 3505 for the cost of calves sold.

3. Field crops:

The total cost of all crops raised

would be obtained from the accounts for this operation at the end of each year. A field record should be maintained for the purpose of allocating monthly costs to the various crops produced, such as wheat and wheat straw, oats and oat straw, harvested corn and corn used for ensilage, etc. The field record would be a columnar form on which direct and indirect crop costs and expenses would be listed in a vertical column along the left side of the form and field costs would be listed in the columns provided for each of the fields used for crop farming. The costs and expenses that should be listed on the field record and the method by which each should be allocated to the fields are as follows:

*Direct costs and expenses:—*

Labor:
The cost of labor charged to farm crop operations (accounts 6101 and 6102) should be charged to the fields on which the various employees worked as shown by the daily or weekly time reports.

Seed:
The cost of seed should be charged to the fields on which the seed was planted as shown by the daily reports submitted by the foremen.

Fertilizer:
The cost of fertilizer should be charged to the fields on which the fertilizer was used as shown by the daily reports.

Taxes (real estate):
Real estate taxes should be allocated to the various fields on the basis of the ratio of the number of acres in each field to the total number of tillable acres.

Crop insurance:
The cost of crop insurance should be charged to fields on which insured crops are planted.

Amortization of development costs:
Amortization of development costs should be charged to the fields previously under development.

*Indirect expenses:—*

Farm implement expenses:
These expenses should be allocated to fields on the basis of the number of hours charged to each field or crop, if a record of such charges is maintained; if it is not maintained, the allocation should be made on the basis of direct labor hours.

Workmen's compensation insurance:
The cost of compensation insurance should be allocated on the basis of direct labor cost.

All other expenses:
The total of all other operating expenses should be allocated on the basis of acreage.

Although the monthly costs of the crop farming operation would be allocated to fields at the end of each month, the cost of crops produced on each field cannot be finally determined until the end of the fiscal year. The monthly costs applicable to fields under cultivation should be transferred to account 1210, inventory — cost of growing crops; the costs applicable to fields under development (i.e., breaking of virgin land, plowing, harrowing, fertilizing, planting and harvesting of starter crops, all for the purpose of preparing the land for regular crop production) should be transferred to account 1940, deferred development costs; and costs applicable to fields on which no crops are grown should be transferred to account 3510, cost of current farming operations. At the end of each year, when total costs are known they should be allocated to the products obtained from each field (grain and straw, etc.) on the basis of their current market values, and the total amount in account 1210, inventory — cost of growing crops, should be transferred to account 1201, inventory—farm products. The cost of each crop produced would be entered in the subsidiary inventory records.

Hay and grain crops will be harvested during the summer months and sold or used as stock feed prior to the determination of their cost. The quantities harvested should be entered in the

subsidiary inventory records and sales and consumption during the period prior to the year end should be costed at estimated prices. In this way, a record of inventory quantities can be maintained, the accounts of operations consuming feed would reflect the approximate cost of such feed, and sales would be costed so that a reasonably accurate statement of profit and loss can be prepared for periods of less than one year.

The process of developing virgin land for the production of crops may take more than one year. Proceeds from starter crops planted on land under development may be used to reduce the development costs or may be taken up as revenue, as desired. The deferred development costs should be accumulated until the end of the year preceding the first year of full production from the land and should be amortized thereafter for a reasonable period as a cost of production from the land.

4. Poultry:

The monthly cost of the poultry operation should be transferred to account 3520, cost of poultry operations. Periodically, physical inventories of poultry flocks should be taken and adjustments reflected in the operation costs in order that profits may be accurately determined.

5. Orchard and garden:

The monthly cost of the orchard and garden operation should be transferred to account 3530, cost of orchard and garden operations. However, when a new orchard is under development the costs of the operation should be apportioned in the same manner as field crops and the cost of development should be deferred until maturity when it should be capitalized.

6. Water plant and distribution system:

Total operating costs of this service department should be allocated monthly to other departments or operations on the basis of estimated water consumption. Charges to other service departments, the owner's residence and to administrative expense should be made on a flat rate basis to facilitate the allocation of other service department costs to the water service department.

7. Machine shop:

As previously explained, all work done by machine shop employees should be recorded on work orders. The total cost of materials charged on all work orders should be recorded by journal entry charging operating supplies, account 9215, and crediting repair and expense supplies, account 1920. Total operating costs of the department, excluding direct labor and operating supplies, should be apportioned to the work orders on the basis of total direct costs. The work orders should be summarized by accounts to be charged and recorded by journal entry.

8. Maintenance of roads and fences:

The total cost of maintaining roads and fences should be distributed to productive operations and to the owner's residence on the basis of acreage.

9. Employees' housing and board:

The costs of housing and feeding employees should be apportioned to productive operations on the basis of labor costs.

10. Owner's residence and personal expenses:

The expenditures made on behalf of the owner would be accumulated as a service operation as a matter of convenience. Total expenditures should be transferred to the owner's personal account at the end of each month.

### Financial Statements

At the end of each month, the following statements should be prepared showing the financial position of the farm enterprise at the end of the month and the results of operations for the period with comparative figures for the preceding year:

| | | |
|---|---|---|
| Balance sheet | Exhibit | I |
| Summary statement of profit and loss | " | II |

Statements of operations for:

| | |
|---|---|
| Dairy | Exhibit III |
| Calves | " IV |
| Field crops | " V |
| Poultry | " VI |
| Orchard and garden | " VII |

The pro forma financial statements presented herewith are intended as a guide to form and content and should be revised from time to time to provide any additional information that may be required. Provision may be made in the forms for additional columns showing the amounts of increases and decreases for the current period, percentages of costs and expenses to sales, etc. The extent to which the financial statements should be so amplified depends upon the requirements of management, and, as a general rule, such amplification enhances the interpretative value of the statements.

## OWNER'S FARM

### EXHIBIT I
### BALANCE SHEET
### OCTOBER 31, 1947 AND 1946

ASSETS

| | 1947 | 1946 |
|---|---|---|
| **Current Assets:** | | |
| Cash | $ | $ |
| Notes and accounts receivable, less reserve | | |
| Employees' loans receivable | | |
| Inventories—farm products | | |
| Inventories—feed and operating supplies | | |
| Total current assets | | |
| **Fixed Assets:** | | |
| Land and buildings | | |
| Implements, tools and equipment | | |
| Orchard | | |
| Livestock | | |
| Less—Reserves for depreciation | | |
| Total fixed assets | | |
| **Prepaid Expenses:** | | |
| Development costs | | |
| Unexpired insurance | | |
| Expense supplies, taxes, etc. | | |
| Total prepaid expenses | | |
| | $ | $ |

LIABILITIES

| | 1947 | 1946 |
|---|---|---|
| **Current Liabilities:** | | |
| Notes payable | $ | $ |
| Accounts payable | | |
| Accrued compensation | | |
| Accrued taxes | | |
| Other current and accrued liabilities | | |
| Total current liabilities | | |
| **Mortgage Payable** | | |
| **Proprietorship:** | | |
| Equity at beginning of period | | |
| Add—Profit for the period | | |
| Less—Personal expenses and drawings during the period | | |
| Equity at end of period | $ | $ |

## OWNER'S FARM

### EXHIBIT II
### SUMMARY STATEMENT OF PROFIT AND LOSS
### OCTOBER 31, 1947 AND 1946

| | Month 1947 | Month 1946 | Year to date 1947 | Year to date 1946 |
|---|---|---|---|---|
| Profit from operations: | | | | |
| Dairy herd | $ | $ | $ | $ |
| Calf herd | | | | |
| Farm crops | | | | |
| Poultry | | | | |
| Orchard and garden | | | | |
| Total profit from operations | | | | |
| Administrative expenses: | | | | |
| Salaries | | | | |
| Taxes and licenses | | | | |
| Depreciation | | | | |
| Traveling expense | | | | |
| Donations | | | | |
| Legal and audit | | | | |
| Bad debts | | | | |
| Other expenses | | | | |
| Total administrative expenses | | | | |
| Other income and charges: | | | | |
| Profit or loss on disposal of capital assets | | | | |
| Interest expense | | | | |
| Miscellaneous | | | | |
| Farm profit for the period | $ | $ | $ | $ |

## OWNER'S FARM

### EXHIBIT III
### STATEMENT OF OPERATIONS—DAIRY
### OCTOBER 31, 1947 AND 1946

| | Month 1947 | Month 1946 | Year to date 1947 | Year to date 1946 |
|---|---|---|---|---|
| Milk sales | $ | $ | $ | $ |
| Operating costs: | | | | |
| Labor | | | | |
| Feed | | | | |
| Operating supplies | | | | |
| Truck and car expenses | | | | |
| Building maintenance and repairs | | | | |
| Road and fence maintenance | | | | |
| Taxes and licenses | | | | |
| Insurance | | | | |
| Fuel, electricity and water | | | | |
| Depreciation | | | | |
| Veterinary | | | | |
| Transfer fees | | | | |
| Testing expense | | | | |
| Death and accident loss | | | | |
| Other operating costs | | | | |
| Less—Costs applicable to dry cows | | | | |
| Operating cost | | | | |
| Profit from operations | $ | $ | $ | $ |
| Milk sales: | | | | |
| Pounds | | | | |
| Quarts | | | | |

## OWNER'S FARM
### EXHIBIT IV
### STATEMENT OF OPERATIONS—CALVES
### OCTOBER 31, 1947 AND 1946

| | Month 1947 | Month 1946 | Year to date 1947 | Year to date 1946 |
|---|---|---|---|---|
| Calf sales | $ | $ | $ | $ |
| Cost of calves sold | | | | |
| Gross profit | | | | |
| Operating costs: | | | | |
| Labor | | | | |
| Feed | | | | |
| Operating supplies | | | | |
| Truck and car expenses | | | | |
| Building maintenance and repairs | | | | |
| Road and fence maintenance | | | | |
| Taxes and licenses | | | | |
| Insurance | | | | |
| Fuel, electricity and water | | | | |
| Depreciation | | | | |
| Veterinary | | | | |
| Registration and transfer fees | | | | |
| Death and accident loss | | | | |
| Other operating costs | | | | |
| Less—Calf costs capitalized | | | | |
| Operating cost | | | | |
| Profit from Operations | $ | $ | $ | $ |
| Number of calves on hand | | | | |
| Cost per calf capitalized | | | | |

## OWNER'S FARM
### EXHIBIT V
### STATEMENT OF OPERATIONS—FARM CROPS
### OCTOBER 31, 1947 AND 1946

| | Month 1947 | Month 1946 | Year to date 1947 | Year to date 1946 |
|---|---|---|---|---|
| Sales: | | | | |
| Grain and hay—current crop | $ | $ | $ | $ |
| Farm products—prior year's production | | | | |
| Total Sales | | | | |
| Cost of sales: | | | | |
| Grain and hay—current crop | | | | |
| Farm products—prior year's production | | | | |
| Total cost of sales | | | | |
| Gross profit from sales | | | | |
| Operating costs: | | | | |
| Labor | | | | |
| Seed | | | | |
| Fertilizer | | | | |
| Operating supplies | | | | |
| Farm implement expenses | | | | |
| Truck and car expenses | | | | |
| Building maintenance and repairs | | | | |
| Road and fence maintenance | | | | |
| Taxes and licenses | | | | |
| Insurance | | | | |
| Fuel, electricity and water | | | | |
| Depreciation | | | | |
| Amortization of development costs | | | | |
| Other operating costs | | | | |
| Less: | | | | |
| Cost of growing crops | | | | |
| Cost of development | | | | |
| Operating cost | | | | |
| Profit from operations | $ | $ | $ | $ |

Sales:

| | | |
|---|---|---|
| Wheat (bu.) | Barley (bu.) | Alfalfa (ton) |
| Oats (bu.) | Corn (bu.) | |

## OWNER'S FARM

### EXHIBIT VI

### STATEMENT OF OPERATIONS—POULTRY

### OCTOBER 31, 1947 AND 1946

| | Month 1947 | Month 1946 | Year to date 1947 | Year to date 1946 |
|---|---|---|---|---|
| Sales: | | | | |
| Poultry | $ | $ | $ | $ |
| Eggs | | | | |
| Total sales | | | | |
| Operating costs: | | | | |
| Labor | | | | |
| Feed | | | | |
| Baby chicks | | | | |
| Operating supplies | | | | |
| Truck and car expenses | | | | |
| Building maintenance and repairs | | | | |
| Road and fence maintenance | | | | |
| Taxes and licenses | | | | |
| Insurance | | | | |
| Fuel, electricity and water | | | | |
| Depreciation | | | | |
| Other operating costs | | | | |
| Operating cost | | | | |
| Profit from operations | $ | $ | $ | $ |
| Sales: | | | | |
| Poultry (lbs.) | | | | |
| Eggs (doz.) | | | | |

## OWNER'S FARM

### EXHIBIT VII

### STATEMENT OF OPERATIONS—ORCHARD AND GARDEN

### OCTOBER 31, 1947 AND 1946

| | Month 1947 | Month 1946 | Year to date 1947 | Year to date 1946 |
|---|---|---|---|---|
| Sales of fruit and vegetables | $ | $ | $ | $ |
| Operating costs: | | | | |
| Labor | | | | |
| Seed | | | | |
| Fertilizer | | | | |
| Operating supplies | | | | |
| Farm implement expenses | | | | |
| Truck and car expenses | | | | |
| Building maintenance and repairs | | | | |
| Road and fence maintenance | | | | |
| Taxes and licenses | | | | |
| Insurance | | | | |
| Fuel, electricity and water | | | | |
| Depreciation | | | | |
| Other operating costs | | | | |
| Operating cost | | | | |
| Profit from operations | $ | $ | $ | $ |

FORM 1.

DAILY REPORT OF DAIRY OPERATIONS

Signature of
Foreman or Super. ____________________ Date ____________

MILK PRODUCTION AND SALES

| | | | Quarts |
|---|---|---|---|
| Production: | | Sales and deliveries:- | |
| Pounds | ______ | Dairy ( lbs.) | ______ |
| Quarts | ______ | Residence | ______ |
| Number of cows: | | *Employees - Charge | ______ |
| Milked | ______ | *Employees - Gratis | ______ |
| Dry | ______ | Calf feed | ______ |
| Total | ______ | *Other (explain): | ______ |
| Cows becoming dry today: | | | ______ |
| Reg. No. ______ ______ ______ | | | ______ |
| ______ ______ ______ | | | ______ |
| ______ ______ ______ | | Total | ______ |

* Inform office of names and quantities delivered

CALVES BORN

| Name | Number | Sex | Name | Number | Sex |
|---|---|---|---|---|---|
| Calf | | | Calf | | |
| Sire | | | Sire | | |
| Dam | | | Dam | | |
| Calf | | | Calf | | |
| Sire | | | Sire | | |
| Dam | | | Dam | | |
| Calf | | | Calf | | |
| Sire | | | Sire | | |
| Dam | | | Dam | | |

FEED CONSUMED

| Type | Pounds | Type | Pounds |
|---|---|---|---|
| Hay | | Processed feed (describe): | |
| Silage | | | |
| Beet pulp | | | |
| Grain (describe): | | | |
| | | | |
| | | | |
| | | | |
| | | | |

FORM 2.

Reg. No. ________

## DAIRY CATTLE RECORD

Tattoo No. ________

| | Date |
|---|---|
| Purchased | |
| Transferred | |
| Sold | |
| Died | |

Name ________________________

Sire ________________________

Dam ________________________

Breed ________________________

DEFERRED CALF COSTS
(Operating cost during months cow is dry)

| Date | Amount | Total | Date | Amount | Total |
|---|---|---|---|---|---|
| | | | | | |

Cost (purchased or raised) $

DEPRECIATION RECORD

| Year | Annual amount | Accumulated amount |
|---|---|---|
| | | |

Reason for sale

Purchaser

Price $

RECORD OF CALVES BORN

| Date | Tattoo No. | Sex | Date | Tattoo No. | Sex | Date | Tattoo No. | Sex |
|---|---|---|---|---|---|---|---|---|
| | | | | | | | | |

FORM 3.

Reg. No. ________

## CALF AND HEIFER RECORD

Tattoo No. ________

| | Date |
|---|---|
| Born | |
| Purchased | |
| Sold | |
| Died | |
| Transferred | |

Name ________________________

Sire ________________________

Dam ________________________

Breed ________________________

CALF COST

| Date | Folio | Cost | Accumulated cost | Date | Folio | Cost | Accumulated cost |
|---|---|---|---|---|---|---|---|
| | | | | | | | |

Remarks:

Reason for sale

Purchaser

Price $

# Investigative Accounting

*By* LEE R. PENNINGTON

MANY individuals who have not followed closely the activities of the Federal Bureau of Investigation appear amazed when informed that a considerable number of Special Agents are qualified in accounting. As a matter of fact, during the period of hostilities the FBI employed a total of 500 Agents who were accountants. With the cessation of hostilities we now have approximately 400 accountants employed on accounting projects.


LEE R. PENNINGTON was born in Martinsburg, West Virginia, but early in life moved to the State of Maryland, where he has since resided. He was graduated from the University of Maryland in 1915, receiving a B.S. degree in Mechanical Engineering. Subsequently in 1928 and 1935, he received his B.C.S. and M.C.S. degrees in Accounting from Southeastern University, Washington, D. C.

In 1917, Mr. Pennington entered the Army as a Second Lieutenant. He was later promoted to First Lieutenant and holds the Army's Silver Star and Purple Heart decorations. Mr. Pennington was formerly Department Commander of the Department of the District of Columbia American Legion. He is presently a member of the Board of Directors of the Young Men's Christian Association in Washington, D. C.

Mr. Pennington entered the service of the Federal Bureau of Investigation on May 6, 1929, and is assigned to the Headquarters of the FBI in Washington, D. C., as an Inspector. This paper comprises the major part of an address delivered by him on December 9, 1947, at a dinner meeting of the Hartford, Conn., chapter of the N.A.C.A., held at the Indian Hill Country Club.


As to the types of cases investigated, many deal with war frauds and violations of the Surplus Property Act. In addition, wartime activities have necessitated investigations involving the Renegotiation Act, both civil and criminal, the Contract Settlement Act, both civil and criminal, and War Fraud Claims.

The normal peacetime activities of FBI accountants deal principally with bank defalcations, violations of the National Bankruptcy Act, accounting phases of mail fraud violations, accounting phases of antitrust cases, and Court of Claims cases. Recently we have had a number of cases referred for investigation dealing with defalcations of railroad employees. The Federal violation investigated in these cases is based on false entries in railroad records.

For a considerable period prior to the actual outbreak of hostilities there was a marked increase in the accounting activities of the FBI, not only in those cases dealing with normal peacetime activities, but likewise in direct connection with the war effort. Accounting investigations have covered the field not only in espionage, sabotage and subversive activities, but likewise in many of the vicious, dishonest practices of our own nationals attempting to defraud the Goverment in connection with war contracts.

In order that you may have an overall picture of the FBI accounting activities, it is my intention to cover not only the current work performed, but likewise to briefly outline some of the wartime work of accountants.

### Accounting in Internal Security Activities

On September 6, 1939, immediately after the invasion of Poland by Germany, the President in a directive charged the FBI with the responsibility

of investigating and coordinating all matters and information relating to the National Defense of this country. It was immediately realized that the FBI in order to comprehend and safeguard our internal security would necessarily have to delve into and be aware of all Axis fund transactions of a suspicious nature for if espionage or sabotage were to be carried on in this country to any extent by organized forces, it would be financed by funds located in the United States.

During the intervening months from September 6, 1939, to the declaration of war upon Germany on December 8, 1941, enemy commerce was allowed to continue and be carried on with institutions and individuals in the United States without any major restrictions in most cases. This flow of trade with foreign-owned business organizations in the United States and the fact that foreign funds were dealt in until the date of the President's freezing order in the summer of 1941, were recognizable to the FBI as an excellent cover for espionage and sabotage activities. It was observed that many of these large business institutions in this country in the normal course of business through their agents and employees were in a position to acquire much information which could subsequently be used to the detriment of this country. Furthermore, these business organizations were in a position to provide foreign exchange needed to finance activities of an inimical nature.

During the period from December 6, 1940, to June 24, 1941, Special Agent Accountants monitored and examined financial transactions aggregating $538,000,000. As a result of this project, there had been compiled over 50,000 cards each containing pertinent information relating to a particular suspicious financial transaction involving persons, firms or business corporations throughout the United States. This information was then furnished to all interested field divisions of the FBI and where the preliminary facts warranted, an investigation was conducted with regard to the persons involved in the transactions.

During the aforementioned period of monitoring of funds, it was observed that the Italian and German Governments were engaged in considerable activity in the liquidation of their assets in the United States and were depleting their bank balances through the withdrawal of cash. This information was of vital importance and served as the basis for the preparation and execution of the President's Freezing Orders which were promulgated shortly thereafter.

The above analyses were discontinued subsequent to the Freezing Orders. However, FBI Agents continued to monitor such accounts and financial transactions of subjects and suspects in cases under investigation.

### National Bankruptcy Act

Annually, many cases alleging criminal violations of the National Bankruptcy Act, which comes within the FBI's investigative jurisdiction, are investigated. Most of these are based upon complaints of creditors after hearings are held before referees in bankruptcy, and there appear to be definite indications of concealment of assets.

One of the principal patterns followed by fraudulent bankrupts is to furnish credit rating agencies with rather glowing financial statements, and thereafter embark on a wave of buying from any wholesalers who will extend credit. From then on until bankruptcy, a barrage of newspaper ads reflects sale after sale, many articles (not just leaders) priced far below cost. For the first few months the bankrupt pays his bills promptly, taking advantage of discounts. Subsequently, his remittances become slower and he finally ignores any attempts on the part of creditors to collect.

The successful solution of these cases in many instances is quite difficult. Many premeditated bankrupts for months prior to bankruptcy, discontinue keeping books; in some instances books and records are concealed and in

still other cases there has not even been a pretense of record keeping. The successful solution of this latter type of case requires imagination, accounting ability, and investigative ingenuity.

I recall in one case, a Special Agent qualified in accounting attempted to locate books after the bankrupt informed the referee he had kept none. The Agent went to the former place of business of a retail store. No books were found, but on the floor of the bankrupt's office were many bills, orders for merchandise, and copies of ads in a local newspaper. The bankrupt, upon interrogation, stated that his financial difficulties were caused by friction between himself and his former partner, followed by the partner's withdrawal from the business. Thereafter, according to the bankrupt, merchandise was advertised at sacrifice prices in order to secure funds to prevent creditors from throwing him into bankruptcy. Sufficient bills were found to ascertain actual costs. These were checked through the newspaper morgue against advertised sale prices, and it was obvious to the investigating Agent that if merchandise had been sold as advertised, more than a sufficient margin existed to cover overhead and still allow a fair profit. Among the bills found on the floor were those from the telephone company for a six-month period. These reflected almost daily calls to a near-by city. Investigation developed that these calls were to a new store operated by the former partner. A check with local drayage firms developed the fact that on numerous occasions, truck loads of merchandise had been hauled at night from the bankrupt's place of business to that of the former partner. Further investigation developed the fact that the two had also been previously involved in bankruptcies to the great detriment of their creditors.

Another case involving the owner of a small store was successfully prosecuted after a Special Agent reconstructed a set of books. When the investigation was initiated, all the accountant had to work with were the certified claims in possession of the referee, part of the cancelled checks, and a very comprehensive report on the questioning of the bankrupt before the referee. At the hearing the bankrupt stated that he deposited all receipts from sales, with the exception of expenses, in his bank account, and he was called upon for complete details on his average monthly expenses.

Purchases for a considerable period were built up by circulation of creditors. Sales were ascertained by a check of bank deposits, plus expenses paid in cash. A check at a local rating agency located a financial statement showing a rather considerable surplus, including real estate, just prior to the bankrupt's embarking on a buying spree. A comparison was made between purchases and sales during the period the bankrupt was operating normally and those during the six-month period prior to bankruptcy. It developed that, notwithstanding the tripling of purchases during the latter period, deposits in the checking account decreased materially. Interrogation of personnel of the various departments of the store developed evidence that several months before bankruptcy the owner discontinued the practice of allowing them to make their daily settlements. All stated that during the last few months of operation, sales increased materially due to the fact competitors could not compete with their prices.

A transcript was made of the checking account, and whenever a check charged thereto was found missing, the accountant endeavored to trace it back. A number of checks charged to the account by the bank were received on incoming remittance letters, and they were traced back to another bank in another city where they had been deposited by the bankrupt under a fictitious name. This account also held much of the cash receipts withheld just prior to bankruptcy. Through an ex-

amination of the cancelled checks it was possible to determine that the bankrupt carried life insurance with substantial cash surrender values. These had been surrendered and the cash deposited in the concealed account. The real estate reflected in the financial statement was located, it having been transferred to the bankrupt's wife some time before bankruptcy. Through bank records it was possible to prove that taxes and expenses on the properties continued to be paid by the bankrupt.

### Bank Defalcations

During the fiscal year 1947, 398 cases of violations of the National Bank and Federal Reserve Acts were referred to the FBI. Defalcations in these cases totalled $4,250,000. During the same period, cases brought to a conclusion resulted in 114 convictions, with fines totalling $86,000 and recoveries amounting to $553,000. It would not be possible to cover the field of bank defalcations in a limited period, but I cannot emphasize too strongly the necessity of adopting adequate accounting controls.

Recently, a teller in a large banking institution received a sentence of fifteen years as the result of a large shortage. The investigation by a Special Agent developed the fact that the shortage commenced some years ago and was initially concealed by lapping deposits. Subsequently, the shortage was charged to the account of a depositor who maintained a uniformly large balance. Had it not been for the fact that the bank used tellers each month to assist in the preparation of depositors' statements, the shortage would have been discovered before it reached such large proportions.

### Railroad Dining Car Thefts

A rather unusual type of case involving cost accounting was investigated a little over two years ago on one of our railroads. Railroad officials noticed that, despite an increase of business, the revenue received from the dining cars on certain sections of one of their trains did not gain proportionately. The dining car officials observed that on other trains with similar service the food cost per meal remained fairly constant. However, on the particular diners of the trains in question the food cost per meal rose to more than a third in excess of the average. The food supplied to each train was the same, its cost was the same, and the portions served were in accordance with the railroad specifications and little spoilage or waste was reported. This led to the conclusion that the dining cars on these sections of the trains were not reporting revenue from all the meals served. Apparently the pipeline carrying revenue from dining car customers to the railroad had sprung a leak.

It was recognized that if this money was being misappropriated by personnel employed on the dining car, these thefts would constitute a violation of the Federal Statute prohibiting theft or unlawful taking by fraudulent device, scheme or game from a dining car of a railroad train moving in interstate commerce. The situation was reported to the Federal Bureau of Investigation.

Special Agents made an analysis of the dining-car records. From the amount of food supplied in the dining cars on these sections of the trains, making proper allowances for spoilage, waste and over-servings, they were able to compute the number of meals which could have been served from the amount of food supplied. From this it was determined how badly the pipe line was leaking.

In order to obtain evidence to show what individuals were responsible for the suspected thefts, FBI Special Agents obtained employment from the railroad on dining cars operating on the suspected sections. Their investigation confirmed the amount of the thefts being perpetrated and indicated the participation by dining car employees in the scheme to defraud.

The essence of the scheme was to serve meals without issuing meal

checks. By serving meals without issuing checks for some, the steward in charge would have on hand at the end of the day cash in excess of the amounts reflected by meal checks. This amount he appropriated, and each waiter received half of the money obtained for meals which he had served at his tables without issuing a new meal check. Of course, the success of the scheme depended upon collusion by both steward and waiters. Neither could operate the scheme without cooperation from the other.

At the conclusion of the investigation, the guilty persons involved received suspended sentences and fines.

### Wartime Government Purchases

I previously mentioned three types of cases which arose as the result of wartime purchases of the Federal Government. These involve the Renegotiation Act, the Contract Settlement Act, and War Frauds. During the fiscal year 1947 savings to the Government in these types of cases totalled $2,327,000. There were 333 convictions and fines of $535,000 were imposed. For the first five months of the current fiscal year savings and recoveries to the Federal Government totalled $1,568,450.

### Contract Settlement Act of 1944

The Contract Settlement Act of 1944 was passed by Congress for the purpose of speedily paying war contractors the fixed compensation due them for the termination of their war contracts and to protect the Government against waste and fraud. The Act provides for the contractor, in the event he is not satisfied with the Government's offer, to bring suit in the Court of Claims of the United States. Thereafter, in order to make an equitable settlement in the civil cases or develop the irregularities in criminal cases, Special Agents of the FBI are in many instances required to make detailed audits of the firm's books.

### Renegotiation Act Cases

With reference to Renegotiation Act cases, as authorized by the Renegotiation Acts of 1942 and 1943, proceedings are instituted by the Government to recover excessive profits arising out of war contracts. When, following prolonged negotiations between a Price Adjustment Board and a contractor, an impasse is reached, a responsible Governmental official makes a determination that excess profits in a stated amount were earned during the year under review by the contractor. Thereafter this amount is paid under protest by the contractor, but his administrative relief is not exhausted until he petitions the Government in the Tax Court for the recovery of the amount so paid.

Special Agents of the FBI are then requested by the Claims Division of the Department of Justice to institute an investigation to determine whether excess profits actually were earned by the contractor. The case is then disposed of either by a civil trial, by dismissal of the petition or by the petitioner's waiving all issues except the constitutionality of the Act, in which case the matter is placed on the Tax Court's reserve calendar.

### War Frauds

With reference to war frauds, many of the cases investigated involve fraudulent pay rolls. A typical case of aggravated fraud in this category is the following:

During the investigation of one fraud case information was developed indicating that another firm, by overstating the number of men and man hours expended on its contract, had defrauded the Government. The investigation disclosed that in submitting its bills the company claimed to have used the services of a subcontractor. A search of the files resulted in the location of false invoices totalling a substantial sum for labor hours allegedly completed. Investigation disclosed that the subcontractor was entirely fictitious. In tracing the fraudulent billheads of this fictitious subcontractor, the services of the Bureau's Laboratory were called upon to

identify the type of paper and to classify the kind of type used in printing the false invoices. The Laboratory also made typewriter and handwriting examinations, and the testimony of the Laboratory examiner in these examinations assisted in identifying the source of the fictitious invoices. Extensive investigation was made by the Bureau Agents to ascertain the printer of the fictitious invoices. A small printing establishment located in a nearby town was found to be the source of the invoices and the operator of this firm definitely identified the individual who had ordered the invoices printed.

As a result of the investigation, indictments were returned by a Federal Grand Jury charging the principals of the company involved with conspiracy to defraud the Government and with submitting false claims against the Government. All entered pleas of guilty and were sentenced to serve terms in the Federal Penitentiary.

# Tax Problems of Pensioners

*By* MIRIAM I. R. EOLIS, C.P.A.

LAW, like all social philosophy, reflects humanity's upward plodding from the era when provision for self and the immediate hour gave way to involved preparations for future old age, and then onward and upward to provision for progeny, for generations to come. A large body of tax law has developed about man's efforts to provide for his more advanced and less lucrative years.

Pensions and annuities have given considerable solace and financial security to scores of people who might otherwise have become charges upon society. The recipients of these pension benefits, who often fall victim to tax tribulations pertaining thereto, may be grouped in several categories.

*First*, there are the Civil Service employees who come into a ready-made plan that has been successfully in operation for many decades. This body of employees usually contributes from its earnings to a pension plan of some kind. In some instances, the employer also contributes to the plan, more often it does not. Generally, the pension or annuity benefits received by this group are subject to federal income tax under the annuity provisions of the tax law. For example, if the employees' total contributions to the fund were, over a period of years $10,000, and upon retirement the annual pensions received amounted to $1,300 a year, 3% of $10,000 or $300 a year would be taxable as income. The remainder of $1,000 a year would be considered return of capital. This method of reporting would be used for 10 years, after which time the entire capital of the fund would be deemed to have been returned. In the 11th year, the entire $1,300 received would be reported as taxable income, as it would every year thereafter.

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In instances where the employer contributes to the pension fund along with the employee, the portion of the pension attributable to the employer's contribution is tax exempt, if the pension plan falls within Sections 23(p) and 165(a) of the Internal Revenue Code. Otherwise the employer's contribution constitutes taxable income to the employee in the year when the employer makes such contribution.

A *second* class of employees, who come under pension plans, are those in private industry. Here we may find some plans initiated primarily to protect employees in their old age and which result in no tax benefit to the employer; and other plans, largely those begun in the years of excess profits taxes, with at least a partial purpose of obtaining a valid deduction for tax purposes for corporate employers. In this category, it will be necessary for us to distinguish the plans which fall under I.R.C. sections 23(p) and 165(a) and those which tread less hallowed ground.

A *third* class of beneficiaries consist of those persons with military service in their wake. In this group we find regular army or navy officers on the

one hand and war veterans on the other. Any retirement pay available to these men is fully taxable unless it represents payment for disability or sickness resulting from active service, in which case it is exempt from tax.

A *fourth* group of pensioners are those falling within the newer and rapidly expanding Social Security benefit groups. These persons exemplify the more fortunate recipients of the modern trend, taxwise, in the handling of pensions and annuities. Funds paid out under the Social Security Act are fully exempt for tax purposes regardless of who constitute the beneficiaries. Occasionally, recipients of these benefits are individuals whose tax problems on income from other sources loom high, but the old age benefits remain available and non-taxable. A curious turn of events may arise, for instance, when a sole owner of a corporation has been receiving a salary and one day discovers he has achieved the advanced age of 65. His government is now willing to compensate him in these days of high pressure living for attaining such an achievement, but only if he "retires". Desirous of obtaining the benefits but not ready to divorce himself from business activities, he dissolves his corporation, continues his business as a sole proprietorship, and for Social Security purposes is now "retired" since he does not receive earnings subject to social security withholding. Or, in the alternative, he may resign from his corporate job and apply for unemployment insurance benefits, and simultaneously make application for old age benefits. Under this second plan, both benefits will be paid to him tax-free.

A *fifth* category consists of those far-seeing individuals who, in the prime of life and at the height of their earning capacity, make provision for regularity of income to themselves in their advanced years in the form of purchased annuities. We shall not deal any further with this group at this time than to say that their annuities when received are taxed in accordance with the laws and regulations relating to annuities.

**(1)—Taxability of retirement pay, disability pay and death benefits as affecting Civil Service employees.**

Civil Service retirement pay is includible in income as an annuity in the years in which received. The amounts withheld from the employee's salary are income in the year in which withheld.

Under the Reg. 111 Sec. 29-22(a)-2,

> ". . . Retired pay of federal and other officers, and pensions or retiring allowances paid by private persons or by the United States (unless specifically exempt) are income to the recipients . . . Amounts deducted and withheld pursuant to the Civil Service Retirement Act . . . from the basic salary, pay or compensation of the employees in the Civil Service of the United States are includible in gross income for the year in which deducted or withheld . . . Compensation received for services rendered as an officer or employee . . . of a State . . . is to be included in gross income."

Under T.D. 5208, C.B. p. 65 (1943), it was held that Civil Service employees must include in gross income amounts withheld under the Civil Service Retirement Act.

In the case of *Miller* vs. *Comm.*, 144 F. (2nd) 287 (1944), it was further held that amounts withheld under the Civil Service Retirement Act must be included in gross income despite the fact that the taxpayer is on a cash basis. The taxpayer, a Civil Service employee, filed a return for 1940. His basic salary for that year was $2,700. Under the Civil Service Retirement Act, 3½% of the basic pay or $94.56 was withheld for the year, and was applied with taxpayer's consent, to an annuity provided by law for his benefit. Taxpayer reported as income for 1940 the $2,605.44 net amount of cash he received. The Commissioner assessed a deficiency on the unreported $94.56. The Tax Court and Circuit Court upheld the Commissioner, pointing out that an old T.D. issued in 1921 required that amounts withheld from basic salary paid employees in Civil Service, should be re-

ported by such employees for income tax purposes.

In the case of state and municipal employees, if they are under a pension plan which meets the requirements of I.R.C. 23(p), as most of these plans do, the employee need not report as income contributions made by the employer. Amounts withheld from the employee's salary for contribution to a pension fund constitute taxable income to the employee in the year in which it is so withheld. After retirement the employee reports his pension as he would an annuity.

Prior to 1939, retired state and municipal employees did not report any part of their annuities in gross income. However, the Bureau held that in computing the amount taxable in 1939 and thereafter, the employee would be deemed to have excluded in prior years all amounts in excess of 3% of his contributions. (I.T. 3364, C.B. 1940-1, p. 19.) The ruling was important in determining the taxable portion of the annuity payments in 1939 and the years thereafter. However it has little application at present, since most employees who retired prior to 1939 have excluded an amount in excess of their contributions and must therefore include the full amounts received thereafter.

Under certain circumstances pensions and death benefits may be properly considered as gifts, and are not subject to income tax. If the contributions to the pension fund are made by a donor who received no consideration therefor in the form of money, goods or services, the recipient of the benefits receives them tax-free.

In the case of *Frank T. Knowles*, 5 T.C. 525 (1945), a retirement fund was set up by the Hebrew Technical Institute, an exempt educational institution, for its teachers. Donations to the fund were made by the Institute and were evidently intended as gifts, and not as compensation for services to its employees. The court held that sums paid to members of the fund upon its dissolution are non-taxable gifts. As to other portions of the fund which were not intended as gifts but as compensation for services, they represent taxable income to the recipients.

In the case of *Anna E. Curtis*, 8 T.C. No. 30 (1947), a widow's vested pension was held taxable as an annuity. Taxpayer, widow of a retired fireman of the District of Columbia, received a $720 annual "relief allowance" from a fund to which her husband had contributed in the form of regular salary deductions. The board administering the fund had discretion only as to the amount of relief to be paid. The Tax Court concluded that the widow's rights were thus vested, and upheld the Commissioner's contention that the pension was taxable as an annuity under section 22(b)(2). Since she had previously received an amount tax free equal to the consideration paid, the full amounts received in the years before the Court, were held taxable.

In the case of *Varnedoe* vs. *Allen* 158 Fed. (2nd) 467 (1946), taxpayer, widow of a deceased fireman in the city of Atlanta, Georgia, received a pension after his death. The Court held that the payments received by the widow were taxable to her on the ground that she received the income in consideration of services furnished by her husband to the city. The pension, therefore, was no gift, but represented taxable income to the widow.

The Tax Court in the *Curtis* case followed the pattern the Circuit Court set in the *Varnedoe* case. However, the Tax Court avoided the vulnerable theory promulgated in *Varnedoe*. The *Varnedoe* case, in holding the widow's pension taxable to her on the ground that it represented compensation earned by her husband violated the principal set down in *Lucas* vs. *Earl*, 281 U.S. 111 (1930), that income earned by one taxpayer cannot be taxed to another. While, for years ending after 1942, the widow might properly be taxed under Sec. 126 (a)(1)(b), the *Varnedoe* decision, which involved years ending be-

fore and after 1942, did not consider the effect of that section.

Disability retirement pay under the Civil Service Retirement Act constitutes income fully taxable to the recipient. In a ruling by the Commissioner (I.T. 3428, C.B. 1940-2, p. 60) it was held that disability retirement pay received from the United States government is subject to federal income tax. A distinction should be made at this point between disability pay under the Civil Service Retirement Act and which constitutes taxable income, and disability pay under the Tyson-Fitzgerald Act pertaining to war veterans, hereinafter discussed, and which constitutes tax-free income.

It has further been held under E.T. 11, C.B. 1937-2, p. 470, that amounts payable from the civil service retirement and disability fund upon the death of an employee of the federal government is includible in the gross estate for estate tax purposes, whether payable to the beneficiary or the estate.

However, in contradistinction to these rulings, under the Federal Compensation Act, it has been held in I.T. 3281, C.B. 1939-1, p. 97, that compensation paid by the United States under this Act on account of death or disability of an employee of the Federal government, resulting from a personal injury sustained by an employee while in the performance of his duty, is not subject to federal income tax.

Under the Railroad Retirement Act, specific provision is made exempting annuities or pensions paid thereunder from income tax. Death benefits under this Act are also exempt from tax. (I.T. 3115, C.B. 1937-2, p. 62; I.T. 3662, C.B. 1944, p. 72.)

**(2)—Taxability of pensions and annuities received by employees in private industry.**

For many years now, some of our larger and more benevolent corporations have been instituting retirement and pension plans for their employees, first, to give employees a greater sense of security and freedom in their jobs, and second, to reduce employment turnover by inducing length of service of employees. Most of the plans created with these motives in view are quite democratic and extensive in coverage of employees. During the last war when salary stabilization came into being, and it became difficult, and even impossible in some cases to give wage and salary increases, many employers sought to effect permissible salary increases in the form of pension plans acceptable to the Treasury Department under I.R.C. Sections 23(p) and 165(a). Furthermore, during the heavily tax burdened years of excess profits taxes, many corporations could afford to be benevolent in setting up acceptable pension plans, since they could thus obtain a deduction for themselves and disseminate good will to employees, with a cost to themselves of only 12½% of their contributions. We therefore find that a great many new pension plans have been set up in the past five or six years.

From the employee's point of view, for income tax purposes, we are concerned with three main problems. First, if the employer contributes to the pension fund, is such contribution included in the employee's income in the year when the contribution is made? Second, if the employee contributes to the pension fund, is his contribution considered part of his income in the year of contribution? Third, is the annuity taxable to the employee when it is received, and if so, on what is the tax based?

To give consideration to the first of these problems, the employer's contribution to the fund does not constitute income to the employee in the year when made if the pension trust is set up in accordance with the requirements of Section 23(p) and 165(a) of the I.R.C. These sections, in the main, require that the contributions and benefits do not discriminate in favor of officers, shareholders and key employees; and that the plan benefits a minimum percentage of the total number of employ-

ees as set forth in the statute. If these requirements are met, the contributions made to the fund by the employer are not taxable income in that year to the employee. However, the cost of the annuity to the employee does not include the employer's contributions. If the pension plan does not conform to the requirements as set forth, the employer's contribution is considered income to the employee in the year of contribution; and the employer's contribution enhances the cost of the annuity to the employee to the extent of the contributions made by the employer.

To consider the second problem, if the employee contributes to the pension fund, irrespective of whether the fund complies with the statutory requirements, the employee's contribution is includible in his income in the year of contribution, and his contribution is considered part of the cost of the fund to him. For example, if the employee receives $5,000 a year and contributes $250 out of the $5,000 to the fund, he must report the full $5,000 for income tax purposes.

To consider the third problem posed, as to taxability of the annuity when received, it is reasonably safe to say that the annuity is always taxable. The question merely arises as to the degree of taxability. There are three hypotheses possible; one, where both the employer and employee make contribution; two, where only the employer makes the contribution; and three, where only the employee makes contribution.

Hypothesis (1): Employer X contributes $200 a year to the fund on behalf of employee A. A contributes $100 a year to the fund. This continues for 20 years. The pension plan meets the statutory requirements.

For the twenty years, A must include in his income the $100 a year of his contribution. He will not include the $200 a year of his employer's contribution as income. At the end of 20 years, A retires and receives $1,000 annually. $600 (3% of $2,000 cost) thereon will be taxed as income; the balance of $400 is considered return of principal. This will continue to be reported thus until the $2,000 cost of the fund is consumed, after which the full $1,000 annuity will be taxable income to A.

If the pension plan does not meet the statutory requirements, A will have to include in his income each year $300 of contribution (X's contribution of $200 and A's contribution of $100), and the cost of the annuity to A will be $6,000 ($200 x 20 years for X's contribution, and $100 x 20 years for A's contribution) on which to base the 3% computation.

Hypothesis (2): Where employer X above alone makes contribution, if the pension plan meets the statutory requirements, employee A need not include any contributions in annual income as the contributions are made: and A's annuity upon retirement is fully taxable since A had no cost.

If the plan does not meet statutory requirements, and X contributes $200 to the fund on A's behalf for 20 years, no contribution being made by A, A must annually include the $200 a year in income. His cost at the end of 20 years is deemed to be $4,000 and the 3% computation is made thereon.

Hypothesis (3): If employer X makes no contribution and employee A contributes $100 a year for 20 years, A must include the $100 a year annually in his income. The cost of the annuity to A at the end of 20 years is $2,000 on which the 3% computation is then made.

Up to this point, we have been giving consideration to formal pension plans set up impersonally and with a view to bettering the situation of company employees generally. However, it often happens that upon an employee's retirement or death, a grateful employer who has made no pension provision for his employee desires to show his goodwill by paying a sum annually to the retired employee or, in case of death of the employee, by paying a sum to his family or estate. Herein arise problems as to

whether such payments constitute compensation for services rendered or gifts, for income tax purposes. Furthermore, the problem of taxability of such sums for estate tax purposes rears its head. A cursory view of Bureau rulings and court decisions seem to confuse the issue rather than clarify it.

However, let us consider some of the situations in which it has been held that payments by the employers constitute compensation for services rendered.

In the case of *Brayton, Adm.* vs. *Welch,* 39 Fed. Supp. 537 (1941), decedent had been an officer of certain corporations. After decedent's death, a corporate resolution was adopted that decedent's salary be continued for a limited period, and be paid to decedent's estate. The court held that these payments constituted compensation for services rendered, and not a gift to the estate.

In the case of *Cora B. Beatty,* 7 B.T.A. 726 (1927), an employer paid an employee a pension after the employee ceased to render services. The court held that since the pension was given by one for whom services had been performed, the past services were the consideration for the payment, and such payment constituted compensation and not a gift. The pension is therefore taxable income to the recipient.

In the case of *E. J. L'Esperance,* 2 T.C. 1268 (1943), taxpayer resigned as branch manager of an insurance company. He waived his rights to certain commissions in consideration of the company's agreement to pay him $500 per month for life. The court in this case held the payments to be compensation and not gifts.

In the case of *John Thomas,* B.T.A., Memo Dec., May 28, 1942, (affirmed CCA-5), a payment specifically designated as a gift was held to be compensation because the element of past services existed.

Payments made to former officers of corporations upon their resignation have, with a fair degree of consistency, been treated as compensation for services rendered, and have been considered as taxable income to the former employee. *Arthur L. Lougee,* 26 B.T.A. 274 (1929); *Willkie* vs. *Commissioner* 127 Fed. (2nd) 953 (1942).

In the case of *Charles L. Jones et al,* 2 T.C. 924 (1943), the employer and the employee entered into a retirement contract to be fully paid for by the employer, and which provided for payments to the employee of $33,000 annually for life, and after his death for annual payments of $25,000 to his wife during her lifetime. If no provision were made for the wife, the annual payments to the employee were to be $41,250. The court held that the amount to be included in the employee's income was $33,000 a year, and not $41,250 as contended by the Commissioner.

The lack of consistency in treatment of moneys paid to retiring employees and their beneficiaries where no formal annuity plans are in existence, is evidenced in the case of *Cunningham* vs. *Comm.* 67 Fed. (2nd) 205 (1942), where an honorarium was paid to the president of a Canadian corporation upon his resignation. The court held this constituted a gift and was not subject to income tax.

Again under I.T. 3329, C.B. 1939-2, p. 153, the Bureau held that payments made to the widow of a deceased officer-stockholder of a corporation by order of its secretary and treasurer were gifts to the widow, and not subject to income tax.

An interesting ruling was handed down by the Bureau in I.T. 3472, C.B. 1941-1, p. 252, on the taxability of a pension received by a United States citizen who had rendered part of his services in the United States and part outside the United States. An employee was employed for a period of 19 years. For seven of these nineteen years, his services were rendered in the United States. For the remaining 12 years he rendered his services outside the United States and was a bona fide non-resident of the United States under I.R.C. Sec-

tion 116 (a) (resident in United States for less than six months of the year). In 1939, the employee retired and was given a pension. In the year of retirement, he was a bona fide non-resident. The Bureau held that the pension was partly taxable and partly exempt. That proportion which the number of years of service rendered in the United States (seven) bears to the entire period of service (nineteen) constitutes the portion of the pension that is taxable. The fact that he was a non-resident of the United States in the year when the pension was received does not exempt the full pension from income tax.

In some cases where annuities or death benefits are paid to survivors of the primary annuitant, problems of valuation for estate tax purposes arise in the decedent employee's estate. Generally, where an annuity plan permits the employee to elect to receive his annuity at a reduced rate for his life, and to have payments continued after his death to a named beneficiary for the remainder of such beneficiary's life, should he or she survive the retired employee, the value of the beneficiary's annuity must be included in the gross estate of the decedent-employee for estate tax purposes. It should be borne in mind that the employee must have had a vested right in the plan to constitute it taxable to his estate. For example, where the plan gives the employee the right to name a beneficiary, but the employer retains the right to withdraw or modify the plan, any amounts received as death benefits by a named beneficiary are not subject to estate tax in the employee's estate, because prior to death, the employee's interest in the death benefits is nothing more than an expectancy.

In the case of *Dimock, Exec.* vs. *Corwin,* 19 Fed. Supp. 56 (1945), decedent had a right to designate the beneficiary of a death benefit to be paid by the corporation of which he had been an officer and employer. It was held that the right was not property within the meaning of the statute, and was not to be valued in the gross estate. However, it should be noted that this decision was handed down before our present law with reference to powers of appointment came into being. It is quite possible that at present, the employee's right to designate a beneficiary might be construed as a power of appointment.

To sum up, if the employer vests all or part of his contributions in the employee, and the vested amount passes to the beneficiary, or to the employee's estate, or designee, the transfer is subject to estate tax. However, if the employee has no vested rights in the plan, either because the plan makes no provision for vesting, and the employer or pension committee decides to pay the deceased employee's widow or other dependents a pension, a lump sum death benefit, a year's salary or any other gratuity, the payment is not taxable in the estate of the deceased since it is termed a gift rather than a transfer by death.

**(3) — Taxability of veterans' pensions.**

Generally speaking, retirement pay of military personnel is subject to federal income tax unless it is received for personal injury or sickness resulting from active service. However, benefits paid to or on account of any beneficiary of a war veteran are exempt from federal income tax.

Under the Tyson-Fitzgerald Act of 1935 disability pensions of retired military personnel were made exempt from tax.

I.R.C. Section 22 (b)(5) provides that pensions, annuities and similar allowances received by members of the Regular Army, Navy or Marine Corps for personal injuries, or sickness resulting from active service are exempt. This rule applies to years ending in 1942 and thereafter. Prior to 1942, all disability allowances were subject to income tax.

In the case of *Alexis R. Paxton,* 8 B.T.A. 1105 (1927), this rule was further elucidated to state that the disability allowances were taxable regardless

of whether the active service was in peace or in war.

It has been ruled that where an officer of the Regular Army has been placed on the retired list for reasons other than physical disability, is later restored to active duty, and thereafter receives retirement pay for physical disability incurred during the second period while serving in active duty, such officer has the same retired status for federal income tax purposes as an officer initially retired for a physical disability.

Half-rate pension payments received by certain disabled enlisted personnel and appointed petty officers in the Navy and Marine Corps are also exempt from tax.

Pensions paid by the government to widows of soldiers, as such, have been held to be tax exempt on the theory that such pensions are not awarded as compensation for services rendered by the widows, and therefore constitute mere gifts to them. However, see the *Varnedoe* and ***Curtis*** decisions discussed above for a more recent interpretation of the problem.

### (4)—Tax consequences of Social Security benefits.

All insurance benefit payments made under the Social Security Act are exempt for federal income tax purposes. This includes primary insurance benefits payable to the retired employee, periodic payments made to his wife, child, widow or parent, and lump sum death payments.

Prior to January 1, 1940, amounts paid to beneficiaries of a decedent were includible in the gross estate for estate tax purposes. This conclusion was reached by the Bureau in a ruling, E.T. 10, C.B. 1937-2, p. 469, on the theory that since no provision of the Social Security Act specifically exempted such payments, they were to be included. Later rulings of the Bureau did not consistently hold with this earlier ruling. Finally, under E.T. 18, 1940-49-10511, it was held that under the Social Security Act, as amended, such payments are unequivocally exempt for estate tax purposes.

### Recommendations

The average individual who retires on a pension suffers certain psychological hazards and setbacks which make it desirable that his financial security be in no way impaired. Usually such an individual has worked all his life and suddenly discovers that the world continues to revolve on its axis and in its orbit without his contribution. He must generally readjust his standard of living quite radically because his pension income rarely equals his earlier earning capacity. He finds more time on his hands than he ever had before, with less money with which to use the time. With his belt tightened and his spirits quelled, there is only one pattern of his past that continues in similar vein—his income remains subject to federal income tax, if his retirement moneys come from private business sources.

The Federal government recognized, in its handling of old age benefits, that such benefits should be made exempt from income taxes. In a similar way and for similar reasons, all retirement pay should be exempt from tax. For the benefit of our economy as a whole, our older population should have available for its use as much spendable money as possible. It should be borne in mind that for every dollar of tax obtained out of retirement income, some form of further old age subsidy by government becomes necessary.

I would therefore recommend, first, that all moneys paid to individuals past the age of sixty, in recognition of services rendered in earlier and more productive years, and which do not exceed annually, fifty per cent of the average annual income of such individual for five years preceding his retirement be made wholly exempt from tax.

A second alternative recommendation is that the present rate of 3% applied to the cost of the fund to determine the annual taxable retirement income be

reduced to one per cent, and furthermore that this method of taxation be utilized as long as the retirement income is paid, and not merely until the theoretical capital cost is fully consumed. If the small investor today puts his money into a savings bank, he cannot get much more than one per cent interest on his money. There is no reason why the tax law should compel him to report three per cent as income on his capital in the retirement fund. Tax laws, indubitably, change more slowly than economic money markets, but it is high time that recognition be given to the change in interest rates.

A further alternative recommendation, in the event that it becomes politically inexpedient to reduce the "3% rule" to a "1% rule", is that a declining scale of income be reported annually instead of the static scale now in use. An insurance company, in setting up tables would be expected to take into account the fact that, as a capital fund is expended, the income receivable from that fund declines. Yet the tax law gives no such recognition. For example, if the employee's total contribution to a fund were $10,000, and in the first pension year he received $1,300, under the 3% rule, $300 would constitute income, and $1,000 would constitute return of capital. After that payment, the capital remaining in the fund is only $9,000. In the second pension year under the present law, of the $1,300 to be received, $300 would again be treated as income and $1,000 as return of principal. Under the proposal herein stated, in the second year only $270, or 3% of $9,000 should be reportable as income and $1,030 should be treated as return of capital. Thus as the capital of the fund declines each year, the income return on the fund would decline proportionately.

A final recommendation is, that after the entire capital of the pension fund has been absorbed, the pension income received thereafter be fully tax exempt. The logic of such a proposal becomes apparent when we recognize that the average pensioner does not retire before sixty years of age. For the next ten years of his life, he receives a pension, a small portion of which is subject to tax. During the years from sixty to seventy, he may possibly augment his income by some additional earnings, or by contributions toward his support by other members of his family, thus affording himself some manner of subsistence. Frequently after about ten years of pension payments, all the pension income becomes subject to tax. At this time, our pensioner is usually well past seventy. His medical expenses are constantly increasing. His earning capacity has usually dwindled to zero. He has generally outlived his brothers and sisters and even his children, so that these sources of help are much diminished; and at this time he becomes an affluent citizen under the tax law and discovers that all of his pension income is subject to tax. Equity requires that this unrealistic approach be corrected.

We live in an era when insurance company tables tell us that the proportion of old people to young people is growing greater each year. Whether this is brought about by the fact that our birth rate is declining, that our normal life span is increasing, or that wars are carrying off too many of our young people, does not attack the focal point of the problem. It merely explains its existence. It is therefore rapidly becoming a social necessity that we develop means of providing for the support of our older population in its declining years. It is evident that many methods will be devised to help solve this problem, as it grows greater by force of numbers. Whether it will be solved through broader private pension planning or through enlargement of publicly supported social security benefits, it is difficult to forecast. However if the present trend toward increasing numbers of older population continues *ad absurdum*, we may some day find that most of our taxpayers are retired employees living on pensions.

# Some Old and New Problems of New York Franchise Taxation

*By* Mortimer M. Kassell

ARTICLE 9-A of the Tax Law which imposes the franchise tax on business corporations was extensively revised in 1944. It made four principal changes from the old law which had been in effect for over twenty-five years.

In the first place it eliminated the arbitrary classification of corporations that had formerly existed. The holding company, the investment trust and the general business corporation had been treated in separate categories and had been separately taxed under different provisions of law. The definition of each of these types of corporations was arbitrary and unrealistic. In addition, it failed to recognize the fact that a single corporation can comprise different aspects. Thus, a corporation can have subsidiaries, and to that extent be a holding company; it can have investments and to that extent be an investment company while the major portion of its activities can consist of the usual business or manufacturing operations. If holding companies and investment trusts are accorded different tax treatment there is no reason why a business corporation, to the extent that it is a holding company, should not have the same treatment. Hence, the first basic change made by new Article 9-A was to eliminate the arbitrary lines that formerly existed between different types of corporations and to place holding companies, investment trusts and general business corporations all under new Article 9-A.

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This paper was recently presented by Mr. Kassell at a regular meeting of the Society.

The second principal change was the elimination of the stock factor from the formula used to allocate entire net income for the purpose of determining business activities within and without the state. Since new Article 9-A segregated investment income and capital and subsidiary capital from ordinary business income and capital, there was no longer any reason to apply a stock factor to business income. The presence of the stock factor along with property and accounts payable in the old allocation formula was silly. It could only have been justified on the view that since income from investments was included in entire net income some recognition should be given to stock in the allocation formula. The elimination of the stock factor in the new allocation formula has gone a long way toward providing a more accurate determination of income within and without the state.

The third principal change was the synchronization of the business period with the privilege period. That changeover has long since taken place and no further consideration of it is now necessary.

The fourth principal change in new Article 9-A was the adoption of the so-called "Massachusetts" rule of al-

location. This is the common three factor method of property, receipts and payrolls. However, a slight variation in the Massachusetts rule was adopted and greater emphasis placed on the location of the goods at the time they are appropriated to the order.

Over three years have elapsed since new Article 9-A became effective. Even though most of the advisory group which thought it up, and several of your members were in that group, are surprised at how well it has worked, there are very few of us who think it is perfect. But considering the complete change in the entire theory and practice of franchise taxation that had been in effect in this State for many years, the new law has worked amazingly well. In no small measure this is due to the continuing efforts of Commissioner Bates and Director Burton of the Corporation Tax Bureau who devote most of their working hours to its administration, as well as the tax practitioners in the State. Naturally, in the first few years a number of "bugs" have been found. Each year I have prepared for the State Tax Commission a number of amendments which have been enacted into law by the Legislature. Many of these were mere technical changes. Some came about as a result of recommendations of members of your Society. I would call your attention to some of the major changes since the inception of the law in 1944.

1. Under old Article 9-A a successor corporation was liable for the franchise taxes of its predecessor. This was omitted from new Article 9-A because the tax was put on a current basis. However, it was soon apparent that a corporation could easily avoid the tax by transferring its assets to another corporation and leaving the state. By Chapter 224 a transferee liability, similar to the Federal law, was inserted into Article 9-A.

2. You will recall that under old Article 9-A combined reports could be permitted or required by the Tax Commission. Under that method in computing entire net income the entire net income of all the corporations included therein, after elimination of intercorporate dividends, was added together. The method of computation was simple and easily administered and auditing of reports was facilitated. A mere check against Federal net income as shown in the Federal return was sufficient. However, new Article 9-A adopted the pure "consolidation" theory whereby a consolidated entire net income was required to be computed, by eliminating not only intercorporate dividends but also all intercorporate profits, receipts, etc. Experience soon showed that this was unworkable, because consolidated net income could not be checked against the Federal net income of each of the corporations. In 1946 by an amendment the system of "combined" reports was again adopted.

3. For many years interest on indebtedness to individual stockholders has been included in entire net income. The question of whether interest on indebtedness to corporate stockholders was also included was not settled, although rulings had been issued in regard to it. By a recent amendment applicable to reports due next May interest on indebtedness to corporate stockholders is taxed in the same way as interest on indebtedness to an individual stockholder.

4. One of the methods of computing the franchise tax has been the so-called "third minimum" method. This imposed a tax at 30% of net income plus officers' salaries, minus the corporation's net loss and $5,000. While this method has not been invoked too frequently during the recent prosperous business years it has frequently accounted in past years for a substantial portion of the revenue from the corporation franchise tax. In order to provide for the smaller business corporations the allowance of $5,000 heretofore used in this calculation was increased to $15,000. In the case of corporations which are subject to tax for less than a full year, under a contem-

plated change, the $15,000 amount will be allocated in accordance with the time during which the corporation was subject to tax.

5. Two other amendments made at the last session of the Legislature should be mentioned. One was to permit a change of allocation in the case of a war facility amortization and the other was the treatment of war loss recoveries. Under the first, by reason of the provision that has been in the law for many years to the effect that no change in the allocation formula could be made even though there had been a change by the Federal authorities, it was impossible to remedy the injustice created where a taxpayer terminated the amortization period with respect to an emergency facility.

The other change was to cover the situation where a corporation in 1942 had written off as an ordinary loss, its investment, for example, in a subsidiary located in an enemy country. When in 1946 a taxpayer found it did not have in fact the loss and restored the deduction previously taken to income; in cases where the loss resulted from an investment in a subsidiary, it was found that such income might be exempt under provisions of new Article 9-A exempting income from subsidiary capital. Such a corporation therefore would have obtained two tax benefits. The amendment treats the recovery of such a war loss as business income of the year in which received.

So far we have taken a quick glance at the major changes made by new Article 9-A and the principal amendments made since its inception. I should like to briefly deal with the important question of allocation. You will recall that old Article 9-A allocated entire net income on the basis of accounts receivable, property and the so-called "stock factor." Since all these items were lumped together to produce a single allocation percentage, investments in stock could wholly distort the allocation of ordinary business income. An earlier State Tax Commission had endeavored, without success, to cure this evil. In order to obtain a more realistic measure of activity within and without the state the entire formula was changed by new Article 9-A. Investment income and business income are separated and each is allocated by a different allocation percentage. The business allocation percentage is obtained by taking the average of each of three factors—the value of the corporation's property, the amounts of its payrolls and of its sales, within and without the state. In place of lumping together all three factors, each of the three factors is treated separately, and an average of the three results obtained.

At the outset of the new law, although there was no intention to increase revenue, few could be certain of its précise effect. It was originally considered that the addition of the new factor, i.e., payrolls, would greatly increase the tax on corporations which were predominantly engaged in manufacturing in New York. Soon after the first reports were filed the State Tax Commission undertook a research job to ascertain the effect of the new law and to obtain information which would be useful in recommending changes to the Legislature. About 8,500 reports picked at random were examined which covered taxes amounting to approximately $111,000,000. Corporations having a net income of from $20,000 to those having an income of many million dollars were included in the survey. While no public announcement has yet been made of the results of the survey, it is safe to say that, contrary to predictions, industries doing most of their business in New York are not penalized by the new law. The research has not been finally completed and is being extended and carried forward.

The factor which causes the most difficulty in any allocation formula is sales receipts. While new Article 9-A conformed generally to the so-called "Massachusetts formula," it was believed necessary to adhere in part to the old

method of allocating sales which had been in effect for many years. That method emphasized the location of the goods at the time of the receipt of the order, more than the place of receipt of the order. Difficulties to taxpayers or the Tax Commission in the handling of this factor have not been great, probably because of the experience under the old law. However, I might mention one problem that has arisen. As you know, a sale of property located within this state at the time of receipt or appropriation to an order is considered as a New York sale. Likewise, a sale of property not located at such time at any permanent or continuous place of business outside the state is also a New York sale if the order is received or accepted in this state. Questions have arisen as to whether an order is received or accepted in this state where a salesman works out of the New York office and accepts an order "on the spot." The New York rule follows the rule prevalent in most states, namely, that in such a case the order is deemed received or accepted at the home office of the salesman.

Recent efforts have been made to change the sales factor. In fact, considerable time was devoted to the topic at the National Tax Conference recently held in Miami Beach, Florida. The suggestion stems from a desire for uniformity among the states so that a sale will not be allocated to more than one state. The suggestion is that the destination of the goods determine where the sale is to be allocated. A moment's reflection shows the inherent difficulties of this plan. Briefly, many sales would not be allocated in even one state. The mere shipping of goods into a state does not confer jurisdiction on that state to impose a franchise tax on the shipping corporation. Even if it did confer such jurisdiction, collection of the tax would be impossible, under the present decisions of the Supreme Court of the United States construing the full faith and credit clause. Another weakness is that the destination rule overemphasizes the "promotional" part of a business to the detriment of the equally important function of manufacturing. Until it can be demonstrated that the destination plan is workable, legally and administratively, I doubt that it will make much headway so far as corporate franchise taxation is concerned.

One other aspect of allocation should be mentioned. You will recall that under new Article 9-A all corporations are entitled to an allocation of investment income, regardless of whether they have a regular place of business outside the state. However, only a corporation which has a regular place of business outside the state is entitled to an allocation of its business income. At the inception of the new law difficulties were encountered in determining what is a regular place of business. In the original regulations, a taxpayer which had goods in a warehouse or in a finishing plant outside of the state was not deemed to have a regular place of business, unless it had its own employees regularly at that place. By an amendment to Article 411 made by Regulations 1947 such a taxpayer is deemed to have a regular place of business outside the state even though it has no employees in attendance at the warehouse or finishing plant. However, a distinction is made between a regular place of business and a permanent or continuous place of business. This distinction becomes important in the problem of allocating sales. You recall that the statute allocates to New York sales of tangible personal property not located at the time of receipt or appropriation to the order at a permanent or continuous place of business maintained by the taxpayer. Accordingly, where an order is received or accepted in New York in order to consider it an "outside" sale it is necessary that the goods be at a permanent or continuous place of business. In order for it to be such a place of business it is still necessary that the taxpayer continuously maintain, occupy and use that place and have one or more employees regularly in attendance.

One additional problem, partially relating to allocation, merits your consideration—that is the question of officers' salaries. Where an officer is also a salesman, all his compensation, whether it be commissions as a salesman, director's fees or officers' salaries, must be taken into account in computing the so-called "third minimum" method of computing the franchise tax. In addition, in the allocation factor, compensation of general executive officers is excluded from the payroll factor. There is considerable merit in the view that commissions earned by an officer who is also a salesman should not be considered as compensation of an officer. As yet no readily workable separation has been developed. The members of the Society, particularly those who are principally concerned with the problem, would confer a public service if they could furnish an administratively workable rule to aid in the solution of this and other problems. The present State Tax Commission, as well as the previous ones, is happy to have an expression of the views of your Society.

# New York State Tax Clinic

*Conducted by* BENJAMIN HARROW, C.P.A.

## Gross Receipts Tax—Barr & Lane, Inc. v. City of New York, et al.

An interesting case was decided by the New York Supreme Court recently, involving the Gross Receipts Tax (See New York Law Journal, January 7, 1948). The plaintiffs brought an action for a declaratory judgment. They asked the Court to hold that certain moneys received by them as agents to be disbursed for the principals to third persons were not taxable receipts. The City and the comptroller made a motion to dismiss the complaint upon two grounds, first, that the Court did not have jurisdiction of the subject of the action and, second, that the action had been commenced after the statute of limitations had expired. While this sounds as if only some technical legal issues were involved, the opinion discusses a number of important aspects of the Gross Receipts Tax Law that vitally affect the entire business community.

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The plaintiff was engaged in the City of New York in the business of performing services in supervising, directing, and managing the construction and alteration of buildings for the owners. As such it was subject to an annual excise tax of 1/10 of 1% on all receipts received in the City of New York from such activity. As part of its services the plaintiff disbursed for the owners considerable sums of money to persons who performed labor or furnished materials in connection with the construction and alteration work. The plaintiffs received a fee for their services.

The comptroller had determined a deficiency in tax for the years 1935 to 1938, inclusive, based upon the inclusion in the gross receipts tax base of the moneys which the principals had entrusted to the plaintiffs to be disbursed to third persons. The comptroller also notified the plaintiffs that if they did not agree with the determination they could apply in writing within 30 days for a hearing. This was done and there was a hearing on January 19, 1943. At the conclusion of the hearing the officer presiding stated that the hearing was closed with the right of either side to reopen. Nothing further happened and no formal decision was rendered, but in June, 1947, the comptroller notified the plaintiff that he would make a final determination unless the plaintiff desired to continue the hearing. It was at this point that the plaintiff brought his action for a declaratory judgment.

On the specific issues raised by the motion to dismiss the Court held that the action was timely in that an action may be instituted within thirty days from the Comptroller's notice of a de-

termination after a hearing. In this case no such notice had been given and so the period of limitation had not as yet begun to run. On the question of jurisdiction the Court held that the issue of whether moneys intrusted to the plaintiffs for disbursement are taxable receipts under the statute or not is a proper one to form the basis for a declaratory judgment. The motion of the City and comptroller was therefore denied.

### Gross Receipts Tax—What Constitutes Receipts

The basis of the General Business and Financial Tax (Gross Receipts Tax) is gross receipts without any deduction for cost of property sold, cost of materials used, labor or any other expense whatsoever. In spite of this sweeping statement the law specifically excludes certain receipts from the definition of receipts. The regulations (Art. 202) enumerate no less than eighteen excludible items. A number of them are relevant to the issue in the above case and the Court will undoubtedly consider them when the case is argued on the merits. Item 4 is reimbursement of loaned money. Item 5 is borrowed money received by the borrower. Item 15 is money received as agent for another person.

Apart from this particular case some of the other exclusions from the tax are of interest. Receipts from the sale or rental of realty are not taxed. Neither are wages and salaries of individuals. Gifts, bequests and devises are exempt. So are amounts received representing judgments for personal damages and damages to business property, the latter however only to the extent of the cost of property. Reimbursement of traveling expenses is not a taxable receipt, nor are discounts on purchases. Trade discounts deducted on the face of the bill are deductible from gross receipts. The regulations state that cash discounts allowed to customers for prompt payment may not be deducted from gross receipts unless these are unconditionally deducted by customers upon settlement of their bills and allowed as a matter of established custom in the trade without regard to the due date. In the latter case the so called cash discount is really a trade discount.

### Gross Receipts Tax—Who Is Subject to the Tax

Every trade, business, profession, vocation or commercial activity carried on for profit within the City of New York is subject to the tax. That includes a corporation, a partnership, or an individual, and the law also covers a receiver, an estate, or a trustee. Taxpayers are further classified into two categories. Those engaged in general business pay a tax measured by gross receipts at the rate of 1/10 of 1%. Those engaged in financial business pay a tax measured by gross income at the rate of 1/5 of 1%. In the latter case cost of goods sold would be deductible.

If gross business receipts do not exceed $10,000 no tax is imposed. This does not mean that every taxpayer is entitled to an exemption of $10,000. If gross receipts exceed $10,000 the taxpayer is subject to tax even though exclusions and deductions reduce taxable receipts below $10,000. Furthermore the $10,000 limitation does not apply to persons engaged in financial business.

### Gross Receipts Tax—Receipts from Sales in Interstate Commerce

Such receipts are included in the measure of the tax upon an allocated basis. Transactions involving the sale of commodities between parties in two states are deemed to be in interstate commerce. This seems to be a realistic definition. The state where title passes or the f.o.b. shipping point is considered of no importance in this connection. However a sale by a New York City vendor to customers located outside the state is not interstate commerce if the property is delivered directly to the

purchaser or his agent within New York State. This would include delivery to a purchaser's warehouse or receiving station in New York City. Delivery to a common carrier of merchandise intended for a purchaser located at a point outside the State is a sale made in interstate commerce.

A shipment by a New York City vendor from a factory or warehouse outside the State of New York directly to the purchaser at a point within the City of New York is construed as an interstate commerce transaction. This too is a most equitable rule. If the vendor purchases the merchandise from an out-of-state source of supply and has the third party deliver directly to the purchaser in New York City the shipment is not one in interstate commerce.

## Gross Receipts Tax—Allocation and Apportionment

The law recognizes that even though a transaction involves interstate commerce it may include activity which is properly attributable to business done within the City of New York and which, to that extent, should be included in the measurement of the tax. To that end a regular allocation formula is provided for apportioning receipts from sales in interstate commerce. To those of us who are accustomed to deal with allocation formulas in connection with the franchise tax and the income tax, the gross receipts tax allocation is of considerable interest. Like the franchise tax there are three factors: property, wages, and receipts. The property factor is the ratio of the average value of real and tangible personal property employed in business within New York City to the total average value of real and tangible personal property whereever employed. Real estate is valued without deduction for mortgages or liens.

The wages and salaries factor is the ratio of total wages and salaries paid to officers and employees who work in or from places of business located within the City of New York to wages and salaries paid to all such officers and employees within the United States.

The receipts factor is the ratio of wholly taxable receipts plus one-third of allocable receipts to the sum of the wholly taxable receipts plus entire allocable receipts.

An average of the three percentages is then computed and this is to be used in allocating receipts from sales in interstate commerce. The regulations provide a ceiling and a floor for the final allocation percentage. Not more than 66⅔% of allocable receipts may be included in the tax base and not less than 33⅓% must be included.

The comptroller is given the power to use a different method of allocation if any of the prescribed formulae work inequitably, and the regulations do prescribe an alternative allocation formula applicable to New York City manufacturers. Such a taxpayer may allocate receipts on the basis of cost of manufacturing and selling the goods shipped in interestate commerce. An amount equal to 50% of the manufacturing and selling costs is deemed to be receipts allocated to New York City under this formula, but this amount shall not exceed 66⅔% of the interstate sales.

## Unincorporated Business Tax—Personal Service Deductions

In computing net income under this tax a deduction is allowed for salaries or personal service compensation of the proprietors. The law provides that this deduction may be taken for an individual or each member of a partnership, if such person is actively engaged in the conduct of the business. The aggregate of such deductions may not exceed gross income less deductions permitted in arriving at the net income subject to the Unincorporated Business Tax. These are the ordinary and necessary business expenses, salaries of employees and rent. Interest, taxes, depreciation, losses, and bad debts are not deductible for this purpose. Furthermore the maxi-

mum deduction for an individual or each member of a partnership may not exceed $5,000.

The question recently has arisen as to whether this personal service deduction will be allowed to a member of a partnership for those years during which he happened to be serving in the armed forces. Normally he would be actively engaged in the conduct of the business. If the latter criterion is to be strictly interpreted the Tax Commission would be within its rights in disallowing the deduction for such partner. However, the inactivity of the partner under the circumstances could be quite involuntary and, if voluntary, is so commendable that the Tax Law itself has recognized such service by giving special consideration to such taxpayers. This is one of those provisions that should be liberally construed. The veteran should not be penalized for doing a patriotic act. In the opinion of this editor the Tax Commission will probably allow this deduction for war years to those taxpayers who were actively engaged in the conduct of a business until they entered the armed forces.

### Exempt Income—Stock Dividends

Stock dividends are not subject to tax. The regulations (Art. 64) define stock dividends to mean new stock issued for surplus or profits capitalized. New stock would not embrace stock once issued and then reacquired by the corporation, that is treasury stock. Payment of a dividend in treasury stock results in taxable income. There is also a provision in the law and regulations that if before or after the dividend distribution the corporation cancels or redeems its stock in such manner as to make the distribution and cancellation essentially equivalent to the distribution of a taxable dividend, the amount distributed in redemption of the stock is treated as a taxable dividend. If the stock received as a dividend is allocated to a beneficiary, the latter receives it tax free.

### Exempt Income—Insurance Proceeds

These are excluded from gross income if paid by reason of the death of the insured. The state law is now in conformity with the federal rule that this exclusion applies whether the proceeds are received in a single sum or in installments and regardless of whether the option to receive installments has been exercised by the beneficiary. If the proceeds of insurance are held by the insurance company and the beneficiary receives interest on such proceeds, the interest is taxable income.

There is an exception to the above exclusion if the installment proceeds are payable to a divorced spouse under a divorce decree. In such a case the installment payments are taxable in full to the divorced spouse.

### Exempt Income—Gifts, Bequests, etc.

Gifts and bequests are of course exempt from tax. Unlike the present federal rule, periodic payments under a testamentary trust payable out of income or corpus if income is insufficient are treated as non-taxable bequests to the beneficiary. The income would therefore be taxable to the trust.

Payments under the Social Security Act or the Railroad Retirement Act are not included in gross income, nor are war bonuses paid to veterans.

### Exempt Income—Interest

Exempt from the state income tax is interest on United States obligations, all of them, including federal farm loan bonds, bonds of the War Finance Corporation, the Reconstruction Finance Corporation and the Home Owners' Loan Corporation. Also exempt is interest on New York State obligations, which of course include political subdivisions of the state. In 1946, the legislature added to this exemption obligations of any authority or instrumentality created by agreement to which New York State is a part.

The regulations include as exempt from tax interest on bonds, mortgages and income debentures, certificates of public and private "limited dividend housing companies" organized under the State Housing Law. The regulations indicate that if the state or a political subdivision purchases property subject to a mortgage, the debt does not become such an obligation of the state as to make the interest exempt from tax. Also taxable is interest on condemnation awards received from the federal or state governments. While there is no specific regulation with respect to interest on a refund of federal income tax there is no doubt that it would be treated as taxable income.

Under the federal law the Supreme Court held that where a creditor bid in property against which he had a mortgage lien and included accrued interest in the bid, he realized taxable income when he received the property in satisfaction of the debt and accrued interest. To prevent the state from adopting a similar rule, the legislature, in 1941, added section 359 2(f) to the law specifically exempting such accrued interest from tax.

### Exempt Income—Improvements Made by Lessee

After years of controversy and litigation Congress finally overruled the Supreme Court by amending the Internal Revenue Code and providing that a lessor who receives real property, upon the termination of a lease, the value of which includes buildings or other improvements erected on the property, does not receive taxable income. He has merely received property which may be worth more than he originally paid for it, but upon which he has not realized any taxable income through a completed transaction. In 1943, the New York State legislature adopted a similar rule by adding paragraph (h) to section 359 (2). The law was made applicable to taxable years commencing on or after January 1, 1942.

The regulations (Art. 811) state that if any of the improvements represent a liquidation in kind of lease rentals, to that extent there is taxable income. If upon the termination of such a lease the lessor held any money in escrow as security for the payment of rent and this was forfeited, it would not be included in the exemption, but on the contrary would represent taxable rental income.

### Exempt Income—Salaries of Officers or Employees of Foreign Governments

These are exempt from state tax on a reciprocity basis if the employee is not a citizen of the United States and if officers of the United States Government performing similar services in the foreign country are granted an equivalent exemption. The foreign officer or employee is taxable on income from any other source. And the legislature, in 1947, exempted compensation of employees of international organizations if foreign governments granted equivalent exemption.

### Exempt Income—Bad Debt Recoveries

The legislature, in 1943, adopted the tax benefit principle with respect to a deduction for a bad debt followed by a subsequent recovery. The recovery is excluded from the gross income only to the extent that the allowance of the deduction in the prior year did not result in a reduction of tax. The deduction for the bad debt must have been taken not more than three years prior to the year in which the recovery was made.

Under the reserve method the recovery must be credited to the reserve account. This decreases the deduction for additions to the reserve.

### New York and Federal Income Tax Laws—Some Differences

The reader is referred to the April, 1947, issue of the *New York Certified Public Accountant* for an excellent

presentation by Harold E. Bischoff of a comparison of the principal features of the federal and New York State personal income taxes. The same issue also contains some material on the differences in both laws, in the New York State Tax Clinic, pp. 257 to 259.

### Franchise Tax on Banks—Reserves for Bad Debts

Under Article 9B a bank may take a deduction, in arriving at net income, for debts ascertained to be worthless and charged off during the year. At the discretion of the Tax Commission a taxpayer may use the reserve method of providing for bad debts by adding a reasonable amount to such a reserve and taking a deduction for this addition. The Bureau of Internal Revenue on December 8, 1947, adopted a new principle of allowing substantial bank reserves to be accumulated to provide for bad debts (Mimeograph No. 6209). The purpose of the reserve is to accumulate a cushion to absorb bad debt losses in deficit years. The salient feature of this reserve is a moving average ratio of bad debt losses to outstanding loans for twenty years. If 1947 is the first year that the bank decides to adopt this reserve method, the first step is to determine the average ratio of losses to outstanding loans for a twenty year period including 1947. In determining this average wholly insured and guaranteed government loans are eliminated, but partially guaranteed loans may be included. Bad debt losses mean net losses after taking into account recoveries for each year. The ratio so determined is applied to total loans at the end of the year. This becomes the reserve for the first year and is the amount that may be charged against income except that in the first year actual bad debts charged off may also be deducted from income.

For 1948 an average 20 year ratio is again determined. In this ratio 1948 year is included and the first year used in establishing the average ratio for 1947 is excluded. The new average then becomes the ratio to be applied to total loans at the end of 1948 to determine the addition to the reserve for 1948. This is the heart of the principle of the moving average. A ceiling is placed on the accumulation of additions to the reserve. The reserve may not exceed three times the moving average of the taxable year applied to outstanding loans at the end of the year.

If in any year the ceiling diminishes due to a lower moving average or lower total outstanding loans at the end of the particular year, no addition to the reserve may be made. The reserve itself need not be reduced. If in any year charge-offs of actual bad debts exceed the reserve the deductible addition to the reserve to bring it up to the prescribed minimum is the amount of the deficit in the reserve plus the amount of the moving average applied to total loans at the end of the year.

The Tax Commission has not as yet expressed any opinion as to whether a bank may use this new reserve method of providing for bad debts for franchise tax purposes. The idea of a moving average appears to be sound and the provision for establishing a ceiling to the reserve is likewise one that should be beneficial to banks. The Tax Commission will probably approve this innovation in providing for bad debts. As a matter of fact if the principle of a moving average is good for banks, it should be extended to other taxpayers as well.

### Personal Income Tax—Residence

One of our members poses an interesting problem. A New York resident in December, 1946, is sent to Detroit by his employer and placed in charge of a business located there. The employee remains in Detroit all of 1947. He establishes a home in Detroit, and in 1947 voted from his Detroit residence. He did not however give up his home in New York and in fact

his wife remained here. He visited New York on two occasions, his total stay here being less than 30 days. Is the employee subject to tax in New York for 1947?

Except for the fact that the taxpayer's wife remained in New York this case is somewhat similar to the one decided by the New York Supreme Court, Third Department, on January 7, 1948. In this case the taxpayer was domiciled in New York but left the state and resided in California for two years. There he maintained a place of abode. He did not maintain a place of abode in New York nor spend thirty days in New York during either of those years. The Court held that he was not subject to personal income tax (*Matter of Ryan et al. v. Chapman et al.*)

The statute taxes residents and, as a rule, this includes a person domiciled in the state. To this provision there is an exception, namely, a person who maintains no permanent place of abode in the state, does maintain a permanent place of abode without the state, and does not spend thirty days of the year within the state. The term resident also includes a person not domiciled in New York but who maintains a permanent place of abode within the estate *and* spends more than seven months of the year within the state.

Our member's problem is a close one. We shall assume that the taxpayer properly established a new domicile in Detroit. Having done so his wife's domicile would normally follow his. But a wife, under modern concepts of domicile, may have a domicile separate from her husband. That would seem to be the case here. If we assume then that the taxpayer had no place of abode in New York in 1947, and is domiciled in Michigan, he is a non-resident of New York and so is not subject to tax in New York except on income earned in New York .

### Constitutionality of the Pennsylvania Franchise Tax Law

A Pennsylvania court recently held uncostitutional a provision of the Pennsylvania Franchise Tax law. The basis of the franchise tax, as in our state, is net income reported for federal tax purposes, as adjusted. Interest on federal government securities issued since March 1, 1941, is included in the base as it is in New York. However, under the Pennsylvania law all interest on state and municipal securities is excluded, differing in this respect from our law.

The court held this to be unconstitutional discrimination against United States securities. A state may not tax federal instrumentalities. Under our franchise tax law income from such instrumentalities is merely included in the measure of the tax, the tax itself being on a right to do business in corporate form. Where, however, interest on state obligations is excluded, there is an obvious attempt to tax indirectly U. S. obligations that may not be taxed directly. The situation may be cleared either by including state obligations in the basis of the tax or excluding interest on U. S. obligations. In our opinion the case was correctly decided. (*Commonwealth of Pennsylvania* v. *The Curtis Publishing Co.*, Court of Common Pleas of Dauphin County, No. 113.)

# Accounting at the S.E.C.

*Conducted by* William W. Werntz

### Insider Profits-Section

Section 16 of the 1934 Act provides, in principle, for the recovery by a listed corporation of any profits made through the purchase and sale of its equity securities by officers, directors or principal stockholders. Profits are recoverable if the purchase and sale, or sale and purchase, occurred within a period of six months or less. The Commission is, however, given power to exempt transactions. In Release 4045, issued February 6, 1948, the Commission gave notice of a proposal to adopt an exemptive rule limiting recoverable profits where the "purchase" is made by the exercise of an option, warrant or similar right. Under the proposed rule, recoverable profit in the case of purchases through exercise of options held more than six months would be limited to the difference between the sales price of the security and the higher of (a) the "cost" of the stock, i.e., cost of the option plus cost of the stock at the option price and (b) the lowest market price of the security in the six months' period prior to the sale. The rule thus would eliminate from recovery some increases in security prices that might occur where options had been held for long periods.

The application of the rule to cases in which the option was granted as part of a compensation plan is not wholly clear. If the corporation had, or upon exercise did, consider the difference between option price and market as compensation and made a charge against earnings in that amount, it seems questionable whether, to that extent, the apparent profit—on a cash basis—is within the intent of Section 16. In such cases, treatment of the option price plus the amount charged as compensation (or reported for tax purposes as income on exercise) as "cost" would seem to solve the problem. But in view of the troubled history of both the tax and financial approach to the problem of accounting for compensation options, it would seem undesirable to rely upon the bare word "cost" in the proposed rule as a sufficient basis on which to reach varying results dependent on whether the company or the recipient had recognized an element of compensation. The issue would appear to be of some importance since it is likely that a very large percentage of the options held by officers, directors and principal stockholders originated in bonus and compensation plans.

William W. Werntz, formerly Chief Accountant of the S.E.C., is now associated with Touche, Niven, Bailey & Smart, C.P.A.'s.

Mr. Werntz is a graduate of Yale University and of Yale Law School, and is a member of the Connecticut Bar. He was formerly an instructor of accounting at Yale University and Yale Law School. He was also an accounting consultant to the O.P.A. and the Treasury Department.

Mr. Werntz is the author of numerous articles which have appeared in technical accounting publications. He is Vice-President of the American Accounting Association.

### Reliance on the System of Internal Control

An unusual paragraph taken from the accountants' report in a recent registration statement reads:

> "There were defects in the system of internal control and accounting procedures in that, except in minor instances, there was no adequately maintained system of inventory and plant control. There was no arrangement for internal audit or for adequate review of daily transactions. These defects have now been remedied by the appointment in June, 1947, of an internal auditor properly instructed and with adequate authority, the setting up of proper

inventory records and the bringing up to date of the plant records and checking them against physical plant—the last two undertakings being not yet completed."

It will be recalled that in the middle 1930's the first paragraph of the accountant's report customarily read as follows:

"We have made an examination of . . . In connection therewith, we examined or tested accounting records of the Company and other supporting evidence and obtained information and explanations from officers and employees of the Company; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions."

It was not until 1939 that specific reference to the "system of internal control" became customary as a result of the Institute's Audit Procedure Committee in Bulletin No. 1 recommending this language for use in the short form of report:

"We have examined . . ., have reviewed the system of internal control and the accounting procedures of the Company, and . . ."

It is doubtless improper to refer to a system of internal control, where system and control there is none, and there have been more than a few reports in which that phrase has, in fact, been left out. The instant paragraph, however, raises the question of whether not merely the utter absence of any system but also the existence of glaring inadequacies in the accounting system calls for special treatment in the accountant's report.

Where major weaknesses exist, the auditor must, of course, modify and usually extend his procedures accordingly. If this be done, it seems reasonable under present thinking to take the position that no mention of the weaknesses or of the changes in procedure is required, save only the exclusion in the report of any reference to the system of internal control, where the weaknesses are so pervasive as to make the usual reference misleading.

On the other hand, the extensive reliance customarily placed on a sound system of internal control by most auditors of large companies has invited a question as to whether the accountant's report ought not to include a specific expression of his opinion or conclusions as to the existing system of internal control. An extreme case of this sort resulted in the following language being included in S.E.C.'s Accounting Series Release No. 13, issued in 1940:

". . . when a registrant during the period under review has not maintained records adequate for the purpose of preparing comprehensive and dependable financial statements, that fact should be disclosed. If, because of the absence or gross inadequacy of accounting records maintained by a registrant, it is necessary to have essential books of account prepared retroactively and for the accountant to enlarge the scope of the audit to the extent indicated in order to be able to express his opinion, these facts also should be disclosed, and I believe it is misleading, notwithstanding partial disclosure by footnotes as in the instant case, to furnish a certificate which implies that the accountant was satisfied to express an opinion based on a test-check audit. Moreover, it is misleading, in my opinion, to state or imply that accepted principles of accounting have been consistently followed by a registrant during the period under review if in fact during such period books of account were not maintained by a registrant or were grossly inadequate, or if it has been necessary for the accountant to make pervasive and extraordinary adjustments of the character under consideration."

That statement dealt with the negative of the question. To put it positively, is the company which maintains its accounting house in excellent order entitled to a different sort of accountant's report than the company which, for one or another (and perhaps a very good) reason has not done so?

### More about Thomascolor Incorporated

The object lesson of *Thomascolor* is its demonstration of the process of what has been called purposive accounting. Probably the major difference between the original and final statements is the tag used to describe the debit resulting from the issuance of certain stock. In the originally filed statements, the tag was "patents and patent application $2,014,941"—with a fairly

detailed explanation of the historical process by which the particular amount was determined. In the statements in the prospectus which finally became effective, "Patents and patent applications" are shown at $1.00 and under a separate caption the remainder is shown as "Other intangibles" subdivided to show separately "Excess of par or stated value of stock issued over net tangible assets acquired on May 20, 1947 $1,593,547" and "Expenses incurred by Richard Thomas Enterprises, Inc." aggregating $421,393.

In a narrow sense, it is difficult to find any accounting principle at issue. The stock was undoubtedly issued. For better or worse, certain "items" were acquired on which the directors set a value derived principally from the par of stock issued therefor. Both the company and the Commission agreed on the need for disclosure of certain information as to predecessor organizations which tended to shed light on the validity and nature of what was "acquired" for the registrant's stock. The revised statements do go into more detail as to the nature of the predecessor "costs" and "expenditures" than did the original filing. Nevertheless, boiled down, the Commission appears to have felt that a balance sheet with patents at $1.00 and "Other intangibles" $2,000,000 was much less apt to invite misconstruction as to "values" of the patents than would be the case where "Patents" were stated at $2,000,000 with a footnote explanation containing the detail disclosed in the amended filing. That position seems to be more a matter of administrative conclusion, based on statutory considerations and couched in accounting language, than a clear-cut accounting proposition.

In a broader sense, a fundamental accounting issue may be involved but is not directly discussed in the opinion. It appeared that the registrant was a direct outgrowth of a group of predecessors all of which, on the facts given, appear to have been under joint control of a small group. A discussion of the extent to which the carrying amount of assets may or may not be legitimately increased in less than arm's length transfers would have been of much more wide-spread significance than the narrow conclusion that resulted in a $1.00 amount for patents.

To what extent is accounting permitted or required to be bound by a valid legal document? If a company by appropriate corporate action issues stock for patents, is accounting to burst through such action and to show the stock as having been issued not for patents, but instead for organization expenses? The only difficulty with a negative answer is the absurdity to which it often leads, a financial statement completely out of kilter with the known economic reality—that A spent $5,000 in developing an as yet unproven mineral deposit (just to get away from the case under discussion) and that in the "cost" sense, no realistic cost above that $5,000 is incurred when A organizes a corporation and issues to himself $5,000,000 par value of stock for his efforts. In practice, the difficulty is that the cases are not usually so clear cut as to fall cleanly and entirely into one category or the other. It is also important to note that even if accounting can not, within the four corners of its philosophy, look through such transactions, the Securities Acts appear to give the Commission adequate authority to require such a result as a matter of presentation under the statute.

One wonders whether the answer may not lie ultimately in the complete omission of financial statements in promotional companies except for the presentation of schedules of current assets and liabilities, of fixed obligations and of actual expenditures on account of development. In such case, neither the fixed assets nor the stock would need to have a monetary amount attached to it, and so for purposes of an initial prospectus, and until operations proved or disproved the claims made, the point at issue in *Thomascolor* would be avoided.

# The Taxpert

*By* Lewis Gluick, C.P.A.

**Memory Lane**

The writer is so tired of taxes, at the end of the season, that he refuses to talk about them unless compelled to. He will, for this issue, take a vacation as a "taxpert" and chat about some accountancy matters which he found interesting in the 29 years of his practice. If you recall having heard some of them before, forgive him. After all, the best musical programs on the air are those which have old music.

* * *

Some 25 years ago we got a summons for jury duty. We were, at the time, engaged on the most interesting bankruptcy case we have ever worked. We went to court armed with a letter from our employer, requesting that our service be postponed until after the case was completed, and stressing that it was under the jurisdiction of the Federal District Court. We found ourselves before a Judge who had a reputation of being tough, and we found the reputation was deserved. At first he refused to listen to us, pounding his bench, and in gruff tones stating, "In this court a Certified Public Accountant is no better than a bricklayer". We pleaded meekly, and eventually he relented and gave us a 30 day stay. And bygosh, at the end of 30 days we served!

* * *

Lewis Gluick, C.P.A., has been a member of our Society since 1924. He is now engaged in practice in Long Beach, California. He is best known as the Shoptalker, under which name he has been writing since 1928.

Our appearances in court have been so few that we can recall them all vividly. There was one in which we were called as an expert witness. The night before the trial, the attorney who had subpoenaed us went over the case, asking us the questions he intended to ask in court. Then, the next morning in court, he could not find his question sheet, and stumbled and hesitated in asking questions to the point where we made a mighty poor witness. We really felt sorry for him. In the end the jury brought in a verdict for his client for just half of what was being sued for.

* * *

Right now, in California, there is an undercurrent of discussion of the two class legislation which was enacted in 1945. We believe that it was the intention of the lawmakers to admit all persons who had any claim to being public accountants on the focal date, and then restrict further admissions to those who passed the C.P.A. examinations. Our recollections of what happened in Florida seem pertinent. That state enacted a two class law in 1926, based, if we remember aright, on Michigan's statute, of which the late and beloved Durand Springer was the godfather. Originally between eight and nine hundred public accountants were registered. What happened? Almost immediately nearly all the best men prepared for, took and passed the C.P.A. examinations. At the other end of the scale, many could not make a living at the profession, and were dropped for non-payment of annual license fees. Death took a small toll. According to the latest available statistics only about 15% of the original group are still practicing as public accountants.

Obviously California, with twelve thousand registered public accountants, has a bigger problem, but the same proportional results can be predicted if the law is not tampered with, to the great benefit, not so much of the accountants but of the public which they serve. It seems to me most unfortunate that New York lags in disposing of the problem which the uncertified, unlicensed public accountant poses.

* * *

Recently we got into a matter of inventory valuation. It was quite simple, but it jogged a cog in our memory, and the story presented below came to mind. You must note that in those days there was no S.E.C., and prohibition had just started.

A certain magazine had a long standing habit of valuing its inventory at cost, and a good system of determining that cost. It had regularly a considerable over-run (there was no paper shortage in those days), and over a long period the inventory of those back numbers mounted steadily. The good C.P.A., who made annual audits, protested that it should be marked down, since sales of back numbers were few. The publisher insisted on carrying them as always. The accountant was obliged to defer to his client's wishes, since the balance sheet he certified plainly showed "Cost".

In 1919, the client's fiscal officer triumphantly showed the auditor a large item of back number sales, all at list price. He crowed as he showed how these back numbers had real value, and regarded the policy of "Cost" as vindicated.

The C.P.A. concealed his sceptiscism, and dug into the back number sales. He found over 95% of them were of one single number, the stock of which had been exhausted. So he looked at the masterfile copy and found that that particular number contained an article on how to construct and operate *a still!*

* * *

Up to just before writing this we thought we had seen or been told just about everything that could happen in tax practice. As usual, we were wrong. A young man came to the office with a set of figures prepared by his bookkeeper, and wanted his 1040 made. We asked the usual questions about dependents, etc. The answer was just himself and wife. Then we asked for the preceding year's return, which he produced. A glance at it and we said, "It's very sad that you lost your son." The man did a "take". "What son!" he exclaimed. We showed him an exemption for a son on the preceding year's return. It is really quite fortunate that he could not find the person who had prepared it. Assault charges are not easily gotten out of. Taxwise he did all right. Went to the Collector's office; told the whole story of how he had signed without reading, and was permitted to pay the tax with only interest added. We didn't intend to talk taxes this month, but this curious item just demanded telling.

# COMMITTEE ACTIVITIES

### Technical Meeting

### on

### New York Franchise Taxes under Article 9 and 9-A.

The experiment with a new type of technical meeting will be continued by your Committee on State Taxation on the evening of April 13, 1948, at the Engineering Auditorium. This meeting, devoted to the New York Corporate Franchise Taxes, will be conducted under the plan outlined in the March issue of this publication. A panel of tax men will give their solution to the specific problems set forth below, undertake a general discussion of the topics raised by the problems, and answer any questions submitted from the floor.

If you have a solution or a partial solution, or tangential problems you would like to hear discussed, write to The State Tax Committee, c/o the editor, indicating if you desire that your name be withheld.

## COMMITTEE ON STATE TAXATION

By Sidney I. Roberts
*Chairman,* Sub-committee on technical meetings

I. *By Joseph Getz, C.P.A.*

A. Compute the amount of the Franchise Tax on Real Estate Corporations under Article 9 for the calendar year 1948 on these facts:

1. *Real Estate, located entirely within the State—*

| | |
|---|---|
| Cost, less depreciation, January 1, 1947 | $1,200,000 |
| Cost, less depreciation, December 31, 1947 | 1,100,000 |
| Assessed value | 1,250,000 |

2. *Interest to stockholders on debenture bonds, the proceeds of which were used to acquire the real estate—*

| | |
|---|---|
| Accrued during the calendar year 1947 and deducted on the Federal return | $ 2,000 |
| Paid during the calendar year 1947 | 1,500 |

3. *Dividends paid during the calendar year 1947* ................ 10,000

B. Suppose that the foregoing corporation were organized on February 1, 1947. When would it be required to file its first return on Form 42CT?

C. Suppose that the foregoing corporation has the following assets:

| | *Average Fair Market Value* |
|---|---|
| Stocks and securities | $ 100,000 |
| Real Estate | 1,250,000 |
| Cash | 15,000 |

The corporation has a surplus of $500,000.

What would be the tax consideration under Article 9 if each of the following transactions were proposed in 1948:

a. Purchase $50,000 U. S. Treasury Bonds, borrowing money for that purpose.

b. Acquire the entire capital stock of a real estate corporation for $100,000, borrowing money for that purpose.

c. Acquire the entire capital stock of a real estate corporation for $50,000, then lend it $100,000, borrowing money for both purposes.

II. *By Benjamin Harrow, C.P.A.*

A Delaware company owns all the stock of a New York Corporation. It presumably has no regular place of business in New York. It has only a statutory office in Delaware. It owns valuable patents. Prior to

1939 it had issued licenses to several corporations in the United States and Canada permitting such corporations to use its patents on a royalty basis. It also permitted the New York corporation to use the patents although there was no formal contract for such license and the company received no royalties for such use. The only income received by the Delaware company from the New York company up to that date was dividends.

In 1939 the Delaware company issued a formal license to the New York Company and thereafter received royalty income from the latter company. The Delaware company has a bank account in Delaware. It holds annual stockholders' meetings in Delaware. The directors, who are also directors of the New York company, occasionally meet in New York. Royalty checks for the Delaware company are received at the New York office of the subsidiary and are then mailed to Delaware for deposit. Other than holding the stock of the New York company and the ownership of the patents, the company does no business. Is the Delaware company subject to tax in New York?

III. *By Robert I. Edelson, C.P.A.*

As to each item set forth below, indicate its effect on the computation of "entire net income" and the manner in which it is reflected on Form 3CT:

1. An excess of contributions paid over the 5% maximum allowable as a deduction, appearing at Schedule M, Item 2, Form 1120.

2. A prior year's net operating loss, deducted on the Federal return.

3. Taxes paid to the United Kingdom, appearing on the Federal returns:

(a) as a deduction (Form 1120, Item 22).

(b) as a credit (Form 1120, Item 37).

4. Interest income from bonds of the Commonwealth of Massachusetts, appearing at Schedule M, Item 19(a)(1), Form 1120.

5. New York Franchise Tax.

6. Interest to stockholders in the case of:

(a) an ordinary business corporation.

(b) an investment company.

7. Dividends received on a minority holding of stock in:

(a) an English corporation.

(b) a New Jersey corporation.

(c) a New York corporation.

8. Dividends received from:

(a) a wholly-owned New Jersey corporation.

(b) a wholly-owned Brazilian corporation.

(c) a corporation of which the taxpayer owns 94% of the outstanding common stock, being the only stock outstanding.

(d) a corporation with an equal number of non-voting preferred and voting common stock outstanding, of which the taxpayer owns 55% of the common and 45% of the preferred.

9. Interest received from a wholly-owned subsidiary corporation:

(a) operating entirely without the United States, and the indebtedness is on open account.

(b) operating entirely without the State of New York, and the indebtedness is evidenced by a bond.

(c) subject to the New York Franchise Tax under Article 9-A, but the subsidiary waives its deduction on its Form 3CT.

(d) which deducts the interest on its Form 3CT and the indebtedness is on open account.

10. Gain on sale of the stock of a wholly-owned subsidiary corporation, reflected at Schedule C, Form 1120.

11. As to each class of stock and indebtedness referred to in 8 and 9 above, indicate its classification as "business capital", "investment capital" and "subsidiary capital" and how it would be reflected on Form 3CT.

IV. *By William D. Hanna, C.P.A.*

In the following situation, what is the investment allocation percentage which would be applied against (a) investment income and (b) investment capital:

The taxpayer's business allocation percentage is 100%. Its "investments" consist of the following:

| | *Average fair market value* |
|---|---|
| United States Treasury bonds | $ 1,000 |
| Indebtedness of a Delaware subsidiary corporation not doing business in New York— | |
| on open account | 3,000 |
| evidenced by bonds | 15,000 |
| Bonds of the State of New York | 1,000 |
| Bonds of the Commonwealth of Massachusetts | 6,000 |
| Bonds of the XYZ Corporation, an unrelated entity | 4,500 |

The percentage of the entire capital or the issued capital stock of the XYZ Corporation, allocable to New York as determined on its New York tax report was—

| | |
|---|---|
| for the *current* year | 1.3% |
| for the *preceding* year | 1.0% |
| Bonds of the ABC Company, a partnership | $ 2,500 |
| Cash | $20,000 |

V. *By Stanley B. Tunick, C.P.A.*

What would be the business allocation percentage in the following case:

The taxpayer is a manufacturer of clocks with offices in New York City and its factory in the State of New York. It has no office or factory outside the State. All finished clocks are sent from the factory to public warehouses outside of the State, from which they are shipped to customers. In some instances the clocks are shipped on consignment. All salesmen are attached to the New York office but travel outside the State to solicit orders. The average fair market value of its property is as follows:

| | | |
|---|---|---|
| Furniture and fixtures, in New York office and factory............. | | $ 2,000 |
| Finished goods in public warehouses outside the State.... | $190,000 | |
| Finished goods in hands of consignees outside the State... | 10,000 | |
| Materials, in process and finished goods within the State.. | 62,000 | |
| Property in transit from the factory to public warehouses.. | 3,000 | |
| Total inventories....................................... | | $265,000 |
| Leasehold improvements, permanently affixed to the property at its office occupied under a ten-year lease.......................... | | 2,000 |
| Factory, land and buildings ...................................... | | 125,000 |
| Mortgage on factory, land and buildings on which mortgage the taxpayer is not personally liable.............................. | | 7,000 |
| Salaries of salesmen, of which it appears that 45% represents compensation for services rendered without the State................ | | 50,000 |
| All other salaries................................................ | | 120,000 |

VI. *By J. B. C. Woods*

There are still many corporations which moved out of New York State, or established New Jersey places of business as a basis for allocation of income, before Article 9A was rewritten a few years ago. Also there are corporations doing business in other states which would find it a convenience to have executive offices in New York State but, because of the terms or the indefiniteness of old Article 9A, did not enter the State.

If it is decided to study the question anew from the point of view of state taxes and business efficiency and convenience, what are some of the points to be considered in such cases?

# CORRESPONDENCE

To the Editor of *The New York Certified Public Accountant:*

I have just read the material under the heading "Mr. Caffrey's Address" on page 151 of The New York Certified Public Accountant for February 1948.

I note that the editor says that Chairman Caffrey's remarks "indicated an understanding of the acountant's task and problems that will be gratifying to all practicing accountants".

While this may be true, generally, there is one exception which I think is important. The point to which I refer is brought out in the language of the sentence beginning in the thirteenth line of the material quoted from Chairman Caffrey's address, which, with underscoring supplied, reads as follows:

> "I assume that the accountant has told me how much the business made or lost during the year and *how much it can pay out without impairing the investment.*"

Presumably the word "investment" is intended to mean the same as is meant by "capital" or similar wording in state laws against impairment. These laws differ from state to state. Interpretation of the meaning of statutory capital and of what constitutes impairment of it under the laws are responsibilities of lawyers, or of courts, not of accountants. Valuations of assets, on a basis other than the accepted historical basis followed in accounting may also be necessary for estimating how much can be paid out without impairment of "investment" or "capital"; such valuations are not within the scope of the accountant's work.

While those who are responsible for determining whether impairment of "investment" or "capital" would or would not result from making proposed payments may use information produced by accounting procedures in arriving at their opinion, they should and do consider other factors and information. Much as members of boards of directors or others might like to have such determination made for them by accounting processes, no accounting formula or procedure has been developed or is likely to be developed which would be even approximately a substitute for legal interpretation and the exercise of judgment in determining the limits beyond which impairment would occur.

I believe that there are few matters on which accountants would more generally agree than this—that accountants' statements do not show, and do not purport to show, generally, how much a company can pay out without impairment of capital. Accountants' statements are basically historical; in contrast, as previously indicated, determination of amounts which can be paid out without impairment requires present valuations (which accountants' statements include only in exceptional cases) and may even require the estimating of future developments. Legal opinion as to the effect of the state law upon the facts would also be necessary.

I am sure that the members of the American Institute of Acocuntants are grateful to Chairman Caffrey for coming to Miami and addressing them at their conference in November 1947. I think that most of what he said was helpful and constructive. At the same time, I think that publication of his statement by a prominent accounting magazine, without objection to the wording underlined in the third paragraph of this letter, may be taken to mean that the profession accepts responsibility for stating how much a company can pay out without impairing capital or investment. We do have a responsibility to show, in the finan-

cial statements customarily presented, on the usual historical basis, how much of the total of assets for which accounting is given came from investments in capital stock (differentiating, frequently, between par or stated value of stock and other amounts invested which may be credited to "capital surplus"), how much came from earnings, how much from creditors and how much from other sources; but it seems clear that we cannot, as acountants, take responsibility for saying how much can now be paid out without impairing capital or investment. Certainly it is true that the accountant who states an amount as "net income" and an amount, usually different, as "surplus" is not saying that either or both of these are amounts which can be paid out without such impairment, nor that they set the limits beyond which payments would result in impairment.

Very truly yours,

CHARLES H. TOWNS

New York, N. Y.
March 1, 1948.

## AN ADIRONDACK VIEW

DO YOU CURL? No, we are not talking about the pate-coverings of members-under-fifty. We refer to that grand and glorious game which descended to us from the stone age in Scotland—curling.

The season is from Christmas to March, the time when we need a muscle recreation with which to find a physical outlet for pent-up emotional stress, commonly known as cussedness. Also, it is well to know about another activity in which things are called something different from what they are, like loans to stockholders being called dividends, and non-capital asset sale gains being called capital-gains, and trusts being called corporations, *ad infinitum.*

Here's the game, for the benefit of 5,000 plus of our 5,000 odd members who know naught of it.

1. A sheet of ice of 138 feet long and 14 feet wide. This is not the rink—the team is the "rink"! This must be very smooth, no bumps; this is no strip-tease affair, too cold for that. However, all losing rinks will complain about the ice, so there is no use in being too fussy.
2. Eight curling stones are needed. These are round with a handle (not a pickle) on top. They look like Yankee tea kettles, and weigh only 40 pounds apiece. Retired curlers use them for papers weights.
3. At each end of the ice four concentric circles are painted under the ice. Four players on each rink each heave two stones down the ice, the idea being just like shuffle board. The poorest player comes first and the best player comes last; he is the captain of the team, the big shot, but is not called by either of these names, he is the "skip".
4. Then you need a mess of brooms, one for each player. If this were called the broom game it would be logical.
5. Now the game. The skip stands at the end—the other end. He holds his broom where the stone is supposed to go. The player braces his back foot in the "hack", swings the stone several times, lets it go with a twist, and prays. The other two players on that rink are down the ice, brooms in hand, alert for the skip's call to "sweep".

   The call comes; both sweep like they never sweep at home, in front of the stone as it slides, until it stops. The theory is that this sweeping smoothes the ice, or heats it, or something, so the stone goes farther. The actuality is that the sweepers get a lot of exercise and can't be worrying about the work undone at the office or the stack of business magazines unread. The game is 95% sweeping.
6. A meet of several teams to compete for various cups is a "bonspiel". All other curlers are "brithers". Sometimes it is difficult to be both comfortably warm and sober at the same time.

Yes sir, its the craziest game we know of, 1% up on golf, just the thing for YOU, my feet get too cold! Plan now for next year!

LEONARD HOUGHTON, C.P.A.
*President et al., Adirondack "Chapter"*

# BOOK REVIEWS

### Accountants' Writing

By John Mantle Clapp. THE RONALD PRESS CO., New York, 1948. Pages vii + 216; $2.50.

*Accountants' Writing* is a manual designed to help accountants improve their writing, particularly that directed to clients. Dr. Clapp undertakes to set up criteria for acceptable utilitarian writing by statistical analysis of several passages, some dealing with accounting matters, some not. For each example he lists total number of words, average clause length, average sentence length, proportion of 1-syllable, 2-syllable, and longer words, ratio of substance words to auxiliary words, and ratio of Saxon to Latin words. He concludes from his analysis that the most effective informational writing is that in which sentences average 18-25 words, and in which words of more than two syllables and Latin words are reduced to a minimum of not more than about 20%.

Having set up his criteria, Dr. Clapp goes on to show by precept and example how the accountant can improve his writing. He discusses word choice, with particular attention to the elimination of jargon and of pomposity. He then shows how heaviness and dullness can be minimized by proper attention to clause and sentence structure and variation, and by paragraph planning. Every section is plentifully supplied with examples from writing actually done by accountants. Besides the examples integrated into the text to illustrate the various points under discussion, Dr. Clapp gives over a considerable part of the book (pp. 102-199) to specimens of writing for clients and for associates, with appropriate commentary. Finally, he discusses in some detail the writing of a paper.

This is a book that accountants, and those preparing to become accountants, should welcome and take to heart. Further, it is a book that the English instructor can have no serious quarrel with. Dr. Clapp insists upon the very points that the teacher of English composition finds he must stress again and again: simplicity, directness, accuracy, care for the whole plan of the paper. And Dr. Clapp does what the English instructor often finds it difficult to accomplish; he presents his material in a way calculated to appeal to people who like to think of themselves first as practical men doing a practical job. The book deserves wide study.

JAMES E. CARVER

Department of English
The City College of New York

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### Challenges to the Accounting Profession—1947.

(Papers presented at the Sixtieth Annual Meeting of The American Institute of Accountants; November 3-6, 1947; Miami Beach, Florida.) 76 pages; $1.00.

The 1947 set of Papers contains, for the most part, the views of prominent non-accountants on such subjects of current interest to the profession as Labor-Management Relations, Accountancy Legislation, Use of Accounting Data in Economies and Statistics, Accounting Services to Management, The Federal Tax Outlook, and Federal Budgetary Problems. The volume belongs in every professional library.

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### Developments in Cost Accounting.

Report of the Cost Accounting Sub-Committee of the Institute of Chartered Accountants in England and Wales. GEE AND COMPANY, LIMITED, London, 1947. 52 pages, 8/6 net.

This booklet represents the report of the Sub-Committee on Cost Accounting of the Taxation and Financial Rela-

tions Committee of the Institute of Chartered Accountants in England and Wales. The instructions to the committee were, "To consider from the accounting point of view the question of cost accounting generally, including the introduction of greater uniformity in costing methods, and to report."

Its report is completed in nine brief sections, covering, in order, an introduction, general considerations, the organization of the accountancy function, elements of cost, overhead expense, distinction between fixed and variable expense, standard costing, uniform cost accounting, and conclusions.

Although at times the material presented may seem to be quite elementary, especially in the United States where so much progress has been made in the field of cost accounting through the efforts of the National Association of Cost Accountants and the public accounting associations, yet for a succinct, carefully thought out report reviewing cost accounting procedures and practices, this book is recommended. To appreciate many of its concise statements fully, the reader must have had either a recently completed collegiate course in cost accounting or a number of years of experience in the field.

The conclusions include the following statements: "(1) A sound costing system must place the same emphasis on cost control as on cost ascertainment. (2) Costs are used for many different purposes and the content of any cost should always be determined by the use to be made of that cost. (3) The cost and financial accounting records should be integrated and complementary. . . . (4) The bases of allocation of overhead expense in all costing systems merit the most careful consideration, as an arbitrary allocation will provide management with misleading figures. . . . (5) The costing system should be so designed as to distinguish between the fixed, variable and semi-variable expense of the business at every stage of cost analysis and absorption. (6) Historical costing . . . fails to present vital control information essential to management. . . . In our opinion the most advanced method of cost control . . . is that of standard costing linked with flexible budgeting of costs incurred in the operation of each individual process. (7) The accountancy profession has an opportunity to lead the future development of the trend towards uniformity of cost accounting within industries."

John J. W. Neuner

The School of Business and Civic Administration
The City College of New York

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**Uniform Cost Accounting and the Principles of Cost Ascertainment.**

Published by The Institute of Cost and Works Accountants, London, 1947. 48 pages; price 5/—.

This little work is introduced with the following statement by Mr. H. D. Jack, President of the Institute:

> "The aim of the Council of the Institute of Cost and Works Accountants has always been to stimulate interest in the evolution of Cost Accounting generally, and this publication is intended to support this tradition. Accordingly, the object herein is to relate the desires for Uniform Cost Accounting to the practical problems likely to be encountered in seeking their fulfilment, and also to offer guidance by outlining a plan of approach."

It reviews, in outline form, the current thinking in the two fields, at a level which will be easily understood by the various groups—professional, managerial and industrial—interested in the subject matter. The historical cost viewpoint is stressed, for the most part.

The three main sections are developed, as follows:

*Uniform Cost Accounting* — Uniform Costs defined; evidences of lack of uniformity in business; the need for uni-

form costing; the development of uniform costing methods; uniform costing methods applied; conditions desirable for the development and application of uniform costing methods.

*The Principles of Cost Ascertainment*—The purpose and aim of the contents; cost ascertainment defined; the purposes of cost ascertainment; benefits of cost ascertainment; kinds of costs ascertainable; requirements for cost ascertainment.

*The Application of the Principles of Cost Ascertainment* — The routine of cost ascertainment; the ascertainment of "The Cost Control Total"; the cost accounting classification of expenses; the departmentalisation of expenses; the absorption of expenses by products and services; the relationship between cost and financial accounts.

# The 104th New York Certified Public Accountant Examination

— NOVEMBER 12, 13 and 14, 1947 —

## THEORY OF ACCOUNTS

**Thursday,** November 13, 1947—9 a. m. to 12:30 p .m., only

**Group I—Answer all questions in this group.**

1 For *each* of the following paragraphs write the *letter* of the paragraph and the *number* of the correct completing phrase: [10]

*a* The M Company has under construction a large additional machine shop for its own use. Construction work in progress applicable thereto should appear on its balance sheet as

(1) a current asset, apart of work-in-process inventory
(2) an intangible asset
(3) an investment
(4) a fixed tangible asset
(5) a part of surplus

*b* The M Company's cash includes a sum of $1,000,000 appropriated by resolution of the board of directors for the construction of a new plant. On its financial statements this amount should be included

(1) On the balance sheet as a current asset
(2) on the balance sheet as a noncurrent asset, specifically identified
(3) on the balance sheet as a fixed asset, included as part of plant cost
(4) on the income statement as a nonoperating expense
(5) on the balance sheet as an allocation of surplus

*c* The trial balance of the P Company as of June 30, 1947, the end of its fiscal year, included opposite the title Estimated Federal Income Taxes Accrued the amount of $27,564.12, which included the company's estimate of the Federal income tax it would have to pay for its 1947 fiscal year and the amount of an unpaid additional assessment for the 1945 fiscal year. This amount should appear on the balance sheet as

(1) a general reserve
(2) a reduction of current assets
(3) a current liability
(4) an allocation of earned surplus
(5) an allocation of other surplus

*d* The S Company leased space in a building for a period of 10 years from January 1, 1946. It spent $25,000 for improvements to the space to adapt it to its needs, the expectation being that such improvements would outlast the period of the lease. The improvements were completed and placed in service on January 1, 1947. On the company's financial statements as of December 31, 1947, and for the year then ended, the amount expended should be shown

(1) on the balance sheet as a noncurrent asset
(2) on the income statement as an operarting expense
(3) on the balance sheet as paid-in surplus
(4) on the balance sheet as a current asset
(5) apportioned between the income statement and the balance sheet, the income-statement portion appearing as an operating expense and the balance-sheet portion as a noncurrent asset

*e* On October 31, 1947, the Y Company issued $1,000,000 of 20-year general mortgage bonds at 105. The premium on these bonds should appear on the company's balance sheet at October 31, 1947, as

(1) a part of capital surplus

(2) a part of earned surplus
(3) a part of the liability, "bonds payable"
(4) a deferred credit
(5) an intangible asset

2 On January 1, 1946, the B Company assigned to the D Company, for a substantial consideration, its lease on a piece of vacant property, which will run until January 1, 1977, with an option of renewal for an additional period of 20 years.

During the year 1946, the D Company constructed on the property a building with an estimated life of 50 years. On January 1, 1947, the building was ready for occupancy and the company installed removable machinery with an estimated average service life of 20 years.

In view of the foregoing facts, state over what period *each* of the following on the D Company's books should be written off; give reasons for your answers: [10]

*a* Bonus paid to B Company
*b* Original cost of the building
*c* Cost of building improvements
*d* Machinery

3 A company administers the sinking fund applicable to its own outstanding long-term bonds. State, with reasons for your selection, which of the following proposals relative to the treatment of sinking fund cash and securities you would recommend: [10]

*a* To mingle sinking fund cash with general cash and sinking fund securities with other securities and to show both as current assets on the balance sheet.
*b* To keep sinking fund cash in a separate bank account and sinking fund securities separate from other securities but on balance sheet to treat cash as a part of the general cash and the securities as part of general investments, both being shown as current assets.
*c* To keep sinking fund cash in a separate bank account and sinking fund securities separate from other securities but to combine the two amounts on the balance sheet under one caption, such as Sinking Fund Cash and Investments, to be listed as a noncurrent asset.
*d* To keep sinking fund cash in a separate bank account and sinking fund securities separate from other securities and to identify each separately on the balance sheet among the current assets

4 State for *each* of the cases listed below, giving the reasons for your answers, whether the expenditures should be charged to an asset account or classified as an expense. If you consider that there are alternative procedures which might be followed state the conditions under which each would be appropriate. [10]

*a* Installation of a machine
*b* Inward transportation charges
*c* Revision of shop layout
*d* Taxes on land

5 During its fiscal year ended October 31, 1947, the S Company, a wholly-owned subsidiary of the P Company, sold materials to the latter at a profit, which it used in constructing a new building for its own use. State how the profit on the sale of these materials should be treated in preparing the following: [10]

*a* The consolidated financial statements of the P Company and its subsidiary as of October 31, 1947, and for the year then ended, respectively
*b* Financial statements in subsequent years

**Group II—Answer five questions from this group.**

6 Your client, a furniture manufacturer, recently organized a department to make toys, utilizing therefor short lengths of expensive hardwoods that were formerly disposed of as waste. In order to settle a dispute between your client's chief accountant and the manager of the toy department, who feels that his department should be charged nothing for this kind of material, you are requested to recommend a method of determining the amount, if any, at which the short lengths should be transferred from the furniture department to the toy department and to explain the reason for your recommendation. Draft the body of a letter to comply with this request. [10]

7 The A Company received a gift of several acres of land adjoining its present plant site. The assessed value of the property is $100,000. The day after the property had been transferred to it, the A Company refused a firm offer of $100,000 for it. The donor had paid $150 for the land 30 years before.

Draft a journal entry to record the foregoing transaction in the accounts of the A Company, indicating in your explanation the reason for selecting whatever value, if any, you use for recording the gift. Facts as to the valuation to be stated, other than those included in the question, may be assumed and stated, if necessary, to develop what you consider an appropriate accounting procedure and to provide adequate supporting reasons for that procedure. [10]

8 A partnership has kept its accounts on the basis of stating assets at cost less appropriate reserves for depreciation or other allowances. At December 31, 1947, a partner who has a 40% interest in profits and assets is to withdraw from the firm. The partnership holds a building under a lease having 30 years of remaining life. Because of increased rental rates since the time when the partnership leased the building from the owner, the lease now has substantial value, although the partnership has paid nothing for it except current rentals. An offer of $450,000 has been received for the lease. The partnership agreement contains no provision as to method of valuing assets in the event of liquidation. State with reasons the following: [10]

*a* Your opinion as to how the lease should be treated to produce equitable results, in computing the amount to be paid to the withdrawing partner

*b* Whether you think the books of the partnership have been correctly kept, with regard to accounting for this lease

9 In August, 1947, the Rex Corpration purchased for its use in manufacturing operations, at a cost of $200,000, real estate consisting of land and a building erected thereon, subject to a mortgage of $125,000, but has not at any time assumed the mortgage. In preparing the company's financial statements as of August 31, 1947, the close of its fiscal year, the controller included the gross cost of the property, $200,000, in fixed assets and the amount of the mortgage, $125,000, in fixed liabilities. The company's treasurer objected, contending that the amount of the mortgage should be shown on the asset side of the balance sheet as a deduction from the gross cost of the real estate and omitted from the liability side of the statement. Would you uphold the controller in his presentation or the treasurer in his contention? Give reasons for your answer. [10]

10 In 1947 the Enterprise Electric Company built a new plant, chiefly with its own labor and under the direct supervision of its own engineers. Pursuant to instructions from the board of directors a percentage of direct labor costs incident to this project was included in the cost of the new plant and credited to the salary accounts of the president, the general manager and the controller. Answer the following: [10]

*a* Discuss briefly the theoretical soundness of the procedure of including in the cost of construction any part of the salaries of such officials as are identified above.

*b* Indicate on what basis, if at all, any portion of such salaries should be charged to the cost of the new plant.

11 A corporation that manufactures a product for which new models are introduced annually shuts down the plant customarily for two months each year for tooling and rearrangement of machines and processes. Describe *two* methods by which the costs and expenses for the two shut-down months may properly be treated in the general accounts of the corporation. [10]

12 Discuss the prevailing concept relative to the treatment of income taxes in the income and surplus statements in *each* of the following cases and indicate the treatement you prefer together with reasons for your choice: [10]

*a* An item resulting in a material increase in income taxes of the current year is credited to surplus.

*b* An item resulting in a material reduction in income taxes of the current year is charged to surplus.

*c* A correction of income tax accruals of prior years is made in the current year.

## COMMERCIAL LAW

**Friday, November 14, 1947—9 a. m. to 12.30 p. m., only**

**Group I—Answer all questions in this group.**

1 [10]

*a* Distinguish between partnership capital and partnership property.

*b* When does the partnership liability begin?

*c* Is an incoming partner liable for the debts and engagements of the firm created prior to his admission to the firm?

*d* State the rule as to a partner's right to be informed of all partnership transactions.

*e* What are (1) general partners, (2) special partners?

*f* What acts will render the special partners liable as general partners?

*g* Jock and Kilroy, partners, took Lee in as a partner. At the time of Lee's admittance, the partnership liabilities were $10,000. One year after Lee's admittance the liabilities were $15,000 and the assets $6,000. The partners decided then to dissolve. What is the liability of each partner under the Uniform Partnership Act?

2 [10]

*a* Are the words "value received" essential to the validity of a note or bill?

*b* In the absence of express authorization by court or trust instrument creating them, state the powers of executors, guardians, trustees, etc., with reference to issuing and indorsing negotiable papers.

*c* What implied warranties are made by an indorser "without recourse" or a transferor by delivery?

*d* What is the effect of an alteration of a negotiable instrument?

*e* What alterations are material?

*f* B signed and gave to A a writing in the following form: "On demand I promise to pay A, or order, $1,000 out of my account No. 17 in the Excel Savings Bank, Newark." Is this a negotiable promissory note?

*g* A note made by Steele was indorsed by Burt and discounted at a bank; the note was not paid and the notary, learning from the cashier of the bank that Burt was dead and that Gail was his executor, sent notice of protest to Gail. Gail, however, had previously renounced his executorship and Fall had been appointed substitute administrator.

(1) Was the notice of protest proper?

(2) Was this the due diligence required of the notary?

3 [10]

*a* Define *consideration* in the law of contracts.

*b* Name the different kinds of consideration and define each.

*c* What kind of consideration is necessary to support a simple contract?

*d* When will the delivery of the debtor's unsecured and unindorsed negotiable note or check discharge a contract to pay money?

*e* What will take a debt out of the statute of limitations?

f X contracted to build a house for Y for $15,000. The specifications called for oak floors throughout the house. After completion, Y discovered that pine flooring had been used. Y refused to make the last payment of $2,000 called for by the contract, attempted to rescind the contract and brought suit for the $13,000 already paid. X counterclaimed for $2,000. What are the respective rights of the parties?

4 [10]

*a* As between bank and depositor:

(1) What is the relation in an ordinary deposit and checking account?

(2) What is the relation in a special deposit for a specific purpose?

(3) Who has title to the deposits in (1) and in (2) above?

(4) What are the rights of set-off of matured debts of a depositor to a bank in a deposit and checking account?

(5) What are a bank's rights of set-off of an immature note from a depositor?

*b* What is a bank's liability for refusing to pay checks of its depositors (1) as to the depositor, (2) as to the payee?

*c* Can a bank charge the depositor's account for payment of the depositor's check received by the bank through a forged indorsement? Explain.

5 [10]

*a* What is an act of bankruptcy?

*b* What are the six acts of bankruptcy?

*c* Is insolvency always a necessary element in connection with bankruptcy proceedings?

*d* In case of bankruptcy of a partnership and the partners, how are the estates distributed?

*e* What right of set-off exists between a creditor and a bankrupt?

*f* Does the right of set-off apply to joint debts and credits?
*g* Does it apply in favor of a bank having money of the bankrupt on deposit?

**Group II—Answer five questions from this group.**

6 [10]

*a* What are the rights of mortgagor and mortgagee in the proceeds of insurance upon the mortgaged property (1) when the mortgagor insures, (2) when the mortgagee insures?

b What are the rights of vendor and vendee under a fire-insurance policy on real estate in case of loss after making the contract of sale but before conveyance?

*c* What are the rights of a life tenant and a remainderman under insurance procured separately by either one as to the other?

*d* Who can collect property insurance in case of loss after the death of the insured?

*e* In case of fire loss what must the insured do to protect his rights under his policy?

f How are the provisions in fire-insurance policies construed that require (1) immediate notice of loss, (2) due or satisfactory proof of loss?

7 [10]

*a* Allen stole a ring from Burt and pledged it with a pawnbroker. Burt demanded the ring from the broker, who refused to deliver it unless he received the amount advanced on it. Burt refused and brought replevin. Was his action maintainable?

*b* Allen delivered silver to Burt, a jeweler, to be made into a medallion. Burt was to receive $50 for his work, 30 days after the delivery of the medallion. After the completion of the medallion, Burt refused to deliver it except upon the payment of the $50, claiming a workmen's lien. Was Burt justified in his refusal?

*c* An automobile was stored with the owner of a garage at an agreed price for care and storage. The defendant's night man, in charge of the garage, took the automobile out for his own purposes without permission and damaged it. Could the owner of the automobile recover from the owner of the garage damages for the injury?

*d* Allen delivered woolen cloth to Williams to be made into ladies' suits, agreeing to pay him $20 a suit. After the suits were finished and before they had been paid for, Fredericks levied upon them under a judgment recovered against Williams. Was the levy good?

8 [10]

*a* Name *four* ways an agency may be terminated by operation of law.

*b* State *four* cases in which an agent may become personally liable to third persons.

*c* What is the rule as to an agent's liability to third parties for nonperformance?

*d* What are the duties of an agent in regard to an accounting to his principal?

*e* What is the rule as to the profits made in the course of an agency?

*f* An agent sent an order in the name of his principal, by mail, the day before the death of the principal, to a merchant with whom he had a general arrangement for goods to be supplied on order during the year. The merchant, who was ignorant of the principal's death, filled the order within a reasonable time. The principal's executor refused to pay for the goods. Can the merchant recover?

*g* A traveling salesman authorized to contract to sell certain securities at par reported to his principal that he had contracted to sell a large quantity at 1% below par. The principal withheld action upon the report for one month and then notified the vendee that the contract was repudiated. Is the principal bound by the contract?

9 [10]

*a* What essential records should a corporation keep?

*b* (1) Are books and records of a corporation admissible in evidence in a judicial proceeding?
(2) What do such records represent?
(3) What steps are necessary to make such records competent evidence?

*c* What are a stockholder's preemptive rights when the capital stock issued is (1) increased, (2) reduced?

*d* (1) What is meant by a stockholder's voting by proxy?
(2) May a proxy appoint another if he is unable to act?
(3) May directors vote by proxy? Why?

*e* Directors of a corporation passed a resolution directing that $5,000 in stock of their company be paid to each director, provided that they procured subscriptions to $1,000,000 of stock of the company necessary for its success. They procured such subscriptions. A stockholder filed a bill in equity to restrain them from issuing stock to themselves for that purpose. Should the stockholder succeed? Why?

10 [10]

*a* Define the term *adjusted basis.*

*b* What is meant by a "substituted basis"? Illustrate.

*c* X had 100 shares of stock that cost him $10,000 in 1943. On July 15, 1945, he made a gift of the 100 shares to Y. The market value was then $15,000. Later Y sold the stock for $20,000. What was Y's basis to compute his taxable gain? What was Y's gain?

*d* In 1945 a taxpayer's net income, without consideration of gain or loss from capital asset transactions, was $10,000. During the year he sustained a net loss of $4,000 from the sale of capital assets held for five months. What was the taxpayer's taxable net income in 1945?

*e* In 1946 the same taxpayer had similar net income, without consideration of gain or loss from capital asset transactions. His capital asset transactions from assets held three months resulted in a net gain of $1,500. What is the taxpayer's taxable net income in 1946, and what is the capital loss carry-over to 1947, if any?

11 [10]

*a* Distinguish between a guaranty and a warranty.

*b* How does the release of a surety by the creditor affect the liability of cosureties?

*c* What effect does alteration of the principal contract without the consent of the surety's have on the surety's liability?

*d* How does extension of time by the creditor to the debtor affect the liability of the surety?

*e* What is the surety's right of contribution, and how is the amount of each contribution determined?

*f* When does the statute of limitations commence to run against the right of contribution?

*g* If there are two sureties on the bond of an insolvent principal and one of them, without knowledge of the existence of a cosurety, is compelled to pay the whole debt, what remedy has he against the cosurety?

12 [10]

*a* What effect do deviation and delay have on a carrier's liability?

*b* How can a common carrier limit its liability?

*c* Is any special form required for a carrier to limit its liability?

*d* What constitutes such delivery as will reduce the carrier's liability to that of warehouseman?

*e* When is a common carrier excused for a failure to deliver goods to the consignee?

*f* A farmer employed Jones, a livery stable keeper, to haul a load of wheat from the farm to market in a neighboring town. While the goods were in transit they were accidentally destroyed (without the fault of the liveryman) by a collision at a railway crossing. Is the liveryman liable as a common carrier? Explain his status.

## THEORY OF AUDITING

**Friday,** November 14, 1947 — 1.30 to 5 p. m., only

*Answer all questions.*

1 State *five* significant provisions for which an auditor should particularly look in examining the Articles of Incorporation of a company and amendments thereto. [5]

2 *a* Explain briefly what is meant by the term *window dressing* as applied to financial statements.

*b* Describe *two* different ways in which such window dressing may be effected. [5]

3 Mention *five* different methods to which dishonest employees may resort in manipulating payrolls. [Do not give variations of the same method.] [5]

4 Enumerate *five* very important items that should be considered by an auditor in the evaluation of the nature and extent of the internal check and control relating to accounts receivable of a merchandising company. [5]

5 Comparison between the interoffice account of City Wholesale Hardware Company with its suburban branch and the corresponding account carried on the latter's books shows the following discrepancies at the close of business, September 30, 1947:

(1) A charge of $870 (office furniture) on HO taken up by branch as $780.

(2) A credit by HO for $300 (merchandise allowance) taken up by branch as $350.

(3) HO charged branch $325 for interest on open account which branch failed to take up in full; instead branch sent to HO an incorrect adjusting memo, reducing the charge by $75 and set up a liability for the net amount.

(4) A charge for labor by HO, $433, was taken up twice by branch.

(5) A charge of $785 was made by HO for freight on merchandise, but was entered by branch as $78.50.

(6) Branch incorrectly sent HO a debit note for $293, representing its proportion of bill for truck repairs; HO did not record it.

(7) HO received $475 from sale of truck, which it erroneously credited to branch; branch did not charge HO therewith.

(8) Branch accidentally received a copy of HO entry dated October 10, 1947, correcting No. 7 and entered a credit in favor of HO as of September 30, 1947.

The balance of the account with the branch on the head office books showed $131,690 receivable from the branch at September 30, 1947. The interoffice accounts were in balance at the beginning of the year.

Answer the following: [15]

*a* What was the balance on the branch books before adjustment?

*b* What is the correct amount of the interoffice balance?

*c* Prepare a work sheet reconciling the amount of $131,690 on the HO books with the adjusted balance.

*d* Prepare journal entry or entries to adjust the branch office books.

6 Outline for use in a balance sheet audit of a mercantile organization a program for the verification of the balance of trade accounts payable when a subsidiary ledger is maintained for such accounts, with a control in the general ledger. [10]

7 The R Company operates a retail store in which all sales are made for cash at the time of the sale and recorded on cash registers by the clerks who make the sales. State with reasons what records of cash and sales the R Company should keep in order to enable an auditor to make a satisfactory verification of these items in a detailed audit of the company's records. [15]

8 In response to a request from a prospective client, criticize briefly, item by item, the form and terminology of the following balance sheet: [15]

Balance Sheet of the ABC Company
For the Year Ended December 31, 1946

| | Assets |
|---|---:|
| Current: | |
| Cash and related items | $ 11,000 |
| Accounts and notes receivable | 758,000 |
| Raw Material (market $100,000) | 160,000 |
| Work in process, cost | 35,000 |
| Finished goods, sales price | 315,000 |
| Supplies | 78,000 |
| Investments | 155,000 |
| Fixed: | |
| Land, buildings, machinery, patents | 1,500,000 |
| Investments | 300,000 |
| Treasury stock | 18,000 |
| Deficit | 800,000 |
| Total assets | $4,130,000 |

**Liabilities**

| | | |
|---|---|---|
| Current: | | |
| Miscellaneous current liabilities | | $ 54,000 |
| Accounts and notes payable | | 826,000 |
| Fixed: | | |
| Mortgages and bonds | | 1,000,000 |
| Preferred and common stock | | 1,700,000 |
| Reserves for depreciation | | 200,000 |
| Miscellaneous reserves | | 350,000 |
| Total liabilities | | $4,130,000 |

9 State what you would accept as satisfactory documentary evidence such as sales invoices, vendor's invoices or other original records, in support of entries in the following: (*a*) Sales Register, (*b*) Sales Returns Register, (*c*) Creditors' Voucher or Invoice Register, (*d*) Payroll, (*e*) Check Register. [10]

10 A public accountant has a financial interest in an enterprise that he audits. Discuss the conditions under which it is proper and not proper for the public accountant to express his opinion on the financial statements of this enterprise. [5]

11 The following accounts appear on the ledger of a city: (*a*) Estimated Revenue, (*b*) Appropriations, (*c*) Encumbrances, (*d*) Unappropriated Surplus. State what evidence you would consider satisfactory in support of entries to *each* of these accounts. [10]

## PRACTICAL ACCOUNTING—Part I

**Wednesday,** November 12, 1947 — 1.30 to 6 p. m., only

*Solve problem* 1 *and either problem* 2 *or problem* 3.

1 Arnold, Bates and Cass, a copartnership, after many years of successful operation as wholesalers, encountered a period of losses, as a result of which the partners agreed to dissolve the partnership and liquidate the business.

Giving consideration to the information below, prepare the following: [30]

*a* A statement to show the amount of cash available for distribution to the partners at September 30, 1947, after the full amount estimated to be required to complete the liquidation has been reserved

*b* A statement to show how the cash available at September 30, 1947, should be distributed to the partners

*c* A balance sheet of the partnership, after effect has been given to such distribution.

[Disregard any adjustments of prepaid or accrued items except as indicated.]

At June 30, 1947, the firm's balance sheet showed assets, liabilities and net worth as follows:

**Assets**

| | | |
|---|---|---|
| Cash | | $ 52,000 |
| Accounts receivable | $106,000 | |
| Less reserve for bad debts | 4,600 | |
| | | 101,400 |
| Notes receivable | | 5,600 |
| Accrued interest on notes receivable | | 100 |
| Merchandise, at cost | | 163,000 |
| Prepaid expenses | | 2,000 |
| Cash surrender value of life insurance | | 12,000 |
| Building site, at cost | | 5,000 |
| Building, at cost | $ 80,000 | |
| Less reserve for depreciation | 26,000 | |
| | | 54,000 |
| Furniture and equipment, at cost | $ 37,000 | |
| Less reserve for depreciation | 15,000 | |
| | | 22,000 |
| Goodwill | | 50,000 |
| Total assets | | $467,100 |

| | | |
|---|---|---|
| **Liabilities** | | |
| Notes payable to bank | $ 30,000 | |
| Accounts payable | 47,000 | |
| Accrued liabilities | 5,500 | |
| Five per cent mortgage on building and land | 25,000 | |
| Total liabilities | | $107,500 |
| Partners' loans | | |
| Arnold | $ 30,000 | |
| Bates | 30,000 | |
| | | 60,000 |
| **Net Worth** | | |
| Partners' capital | | 299,600 |
| Total liabilities and net worth | | $467,100 |

The net worth of $299,600 consisted of the following amounts:

| | *Debits* | *Credits* |
|---|---|---|
| Arnold—Capital, balance 1/1/47 | | $217,000 |
| Arnold—Drawing, net debits, six months ended 6/30/47 | $12,380 | |
| Bates—Capital, balance 1/1/47 | | 131,000 |
| Bates—Drawing, net debits, six months ended 6/30/47 | 2,300 | |
| Cass—Capital, balance 1/1/47 | | 22,300 |
| Cass—Drawing, net debits, 6 months ended 6/30/47 | 5,239 | |
| Profit and loss—net loss for six months ended 6/30/47, before allocation of partners' salaries, interest on investment, etc. | 50,781 | |

The partnership agreement provided that annual salaries be credited to the partners as follows:

| | |
|---|---|
| Arnold | $ 5,000 |
| Bates | 12,000 |
| Cass | 25,000 |

In addition, interest at the annual rate of 6% was to be credited to each partner on the basis of his capital account balance at the beginning of the year. After the foregoing provisions for partners' salaries and interest on partnership capital had been complied with, the resultant profit or loss was to be distributed equally among the partners.

The firm discontinued operations on June 30, 1946. No credit to partners' accounts for interest on their investments or for salaries was to be applied after this date. It was agreed, however, that Cass should dispose of the assets as rapidly as possible and be paid the sum of $10,000 from the proceeds for his service as liquidator.

On September 30, 1947, Cass reported collections as follows:

| | |
|---|---|
| Accounts receivable | $ 78,000 |
| Notes receivable | 2,500 |
| Interest accrued on notes receivable | 50 |
| Merchandise sales | 96,000 |
| | $176,550 |

The cost of the merchandise sold was $108,000. Expenses of liquidation, including $5,000 of the compensation to be allowed Cass, amounted to $28,000. Arnold and Bates agreed to assume the responsibility for carrying the life insurance policies on their respective lives. Beneficiaries were consequently changed and the cash surrender values charged against the partners as follows:

| | |
|---|---|
| Arnold | $ 6,000 |
| Bates | 5,000 |

The cash surrender value of $1,000 on the policy on Cass's life was realized in cash.

Arnold's offer to purchase the building and site for $50,000 and to assume the mortgage of $25,000 and accrued interest thereon in the amount of $500 was accepted by the other partners.

Cass also reported that by September 30, 1947, he had paid all accounts payable and accrued liabilities and had settled the firm's obligation to the bank for $29,850, an allowance having been made for the unused portion of the discount, included in prepaid expenses. It is estimated that in addition to the $5,000 yet to be paid to Cass for his services in liquidating the business $5,000 will be required for other expenses of liquidation.

2 From the information below, prepare the following statements, supported by whatever explanatory schedules you consider necessary: [20]

*a* Statement to show at what list price and at what net price per pound Yip should be sold

*b* Statement to show at what list price and at what net price per gallon Zip should be sold

*c* Condensed income statement to show, separately and combined, the results of operations in Yip and Zip, on the assumption that the entire quantity of each product manufactured will be sold at the respective prices indicated in the statements prepared in answer to *a* and *b*.

Chemco, Inc. has perfected a process for producing from the three raw materials, A, B and C, two chemical compounds, Yip and Zip.

The raw materials are required in the following proportions by weight:

| | |
|---|---|
| A | 3 parts |
| B | 5 parts |
| C | 2 parts |
| | 10 parts |

The following diagram illustrates the manufacturing process:

Raw Materials
A, B, C
|
Mixing and Blending
|
Cooking
|
Yip — Pre-Zip

Yip
|
Drying and Packaging

Pre-Zip
|
Electrolysis
|
Filtering into Drums

One hundred thousand (100,000) pounds of raw material will be processed. The unit costs of the three raw materials are as follows:

| | |
|---|---|
| A | $ 2 per pound |
| B | 50 per ton |
| C | 4 per gallon |

Other costs of production are estimated to be:

| | |
|---|---|
| Mixing, blending and cooking | $16,090 |
| Additional costs applicable to Yip: | |
| Drying and packaging | 4,660 |
| Additional costs applicable to Zip: | |
| Electrolysis and filtering to drums | 6,920 |

The cooking process reduces the weight of the combined raw materials by 40%.

Out of 100,000 pounds of original raw materials 20,000 pounds of pre-Zip are obtained. Of the pre-Zip electrolyzed, 25% becomes a nonmarketable precipitate, the remainder, a liquid, being filtered into 50-gallon drums without further attention.

The cost of drums, which are returnable and for which customers are to be charged specifically, is not to be included in either the cost or the price of Zip.

Each product is to be sold on the basis of a list price, less 35% and 10%. Of the net selling price of each product, 25% is to be allowed for selling, administrative and general expenses (including provision for income tax) and 20% for net profit after provision for all costs and expenses.

The company has never marketed either of the products but has demonstrated the existence of markets for both if they can be manufactured to sell at suitable prices. Its experience in producing both these and other chemicals leads it to believe that the above estimates of cost relative to the processing of 100,000 pounds of the three raw materials combined are reliable as a basis for setting a price for each of the products to be manufactured therefrom.

[Note: One gallon of Zip weighs 7.5 pounds.
One gallon of Raw Material C weighs 8 pounds.]

3 From the data below, which show the ledger balances of the Water Department of the Town of G, at October 1, 1946, and reflect the department's subsequent operations during the year ended September 30, 1947, prepare a columnar work sheet from which balance

sheets of the Water Department's Operating Fund, Sinking Fund and Capital Fund as of September 30, 1947, and a Statement of Operations for the year then ended can be readily drawn. [20]

Balance on January 1:

| | |
|---|---|
| Cash | $ 153,678 |
| Sinking fund cash | 207,843 |
| Accounts receivable | 327,926 |
| Stores inventory | 136,052 |
| Supplies | 20,737 |
| Sinking fund investments | 962,500 |
| Plant and property | 17,212,767 |
| Accounts payable | 33,996 |
| Accrued interest payable | 87,676 |
| Accrued liabilities | 2,122 |
| Bonds payable | 6,747,000 |
| Reserve for depreciation of plant and property | 96,130 |
| Reserve for retirement of bonds | 41,333 |
| Reserve for service connection replacements | 7,491 |
| Operating surplus | 465,775 |
| Sinking fund reserve | 1,170,343 |
| Capital surplus | 10,369,637 |

Summary of the transactions for the year:

| | | |
|---|---|---|
| (1) | Sales of water billed | $ 832,952 |
| (2) | Other revenue billed | 90,951 |
| (3) | Collections of accounts receivable | 880,954 |
| (4) | Other income billed through accounts receivable | 35,234 |
| (5) | Accounts receivable of prior years written off | 12,840 |
| (6) | Invoices for stores | 63,172 |
| (7) | Invoices for the following expenses were approved: | |
| | Administration expense | 139,303 |
| | Production expense | 41,976 |
| | Distribution expense | 176,099 |
| (8) | Invoices for supplies | 1,046 |
| (9) | Income of prior years received not previously recorded | 5,642 |
| (10) | Investments purchased for the sinking fund | 570,000 |
| (11) | Stores used during the year | 61,299 |
| (12) | Supplies used | 6,474 |
| (13) | Outstanding bonds became due and were paid, amounting to | 79,000 |
| (14) | Warrants were issued for the payment of interest | 295,190 |
| (15) | Warrants were issued for the additions to plant and property costing | 145,269 |
| (16) | Interest expense for the year amounted to | 293,261 |
| (17) | The reserve for bond retirement was increased by | 79,250 |
| (18) | Appropriated from operations to the sinking fund | 90,000 |
| (19) | Warrants were issued to pay vouchers | 401,624 |
| (20) | Warrants were issued for all accrued liabilities except interest | ...... |
| (21) | Sinking fund investments sold | 324,200 |
| (22) | Interest received from sinking fund investments | 63,751 |
| (23) | Depreciation on plant and properties | 24,854 |
| (24) | The reserve for service connection replacement was increased to | 10,491 |

## PRACTICAL ACCOUNTING—Part II

**Thursday,** November 13, 1947 — 1.30 to 6 p. m., only

*Solve both problems.*

4 From the information below, prepare the following: [25]

*a* A statement of the company's loan account with X Bank for the two months of September and October 1947

*b* A statement showing quantities of purchased materials covered by trust receipts at October 31, 1947

*c* A statement of the balance of the Assigned Accounts Receivable account at October 31, 1947

*d* A statement showing the quantity of the company's product in inventory at October 31, 1947

The ABC Company started business on September 1, 1947. On that date it entered into an agreement with the X Bank to finance the purchase of a commodity under a trust receipt arrangement. Under the terms of the agreement, the suppliers of the ABC Company draw drafts against the X Bank for *all shipments* to the company's plant. The company then gives the bank a trust receipt for each shipment.

In converting the commodity purchased into the product which it sells, the company sustains a quantity loss of 4%, adjustment for which is made when remittances to the bank are made.

All shipments *from the plant* are charged to Assigned Accounts Receivable and remit-

tances to the bank for the purchased quantities used in such shipments are made as the assigned accounts receivable are collected. [Other sales of the company which result from direct shipments from their suppliers to their customers are not financed by the bank.] Remittances to the bank are based on an "average price per pound." For the first half of September a price of $.1475 per pound was agreed upon. For each succeeding half-month period the average price is to be calculated by dividing the dollar balance in the loan account at the beginning of such period by the number of pounds for which the company has not paid at the same date.

The books of the company reflect the following for the period from September 1, 1947, through October 31, 1947:

| | Purchases Financed by X Bank | | Sales and Collections on Assigned Accounts Receivable | | | |
|---|---|---|---|---|---|---|
| | | | *Sales* | | *Collections* | |
| | *Pounds* | *Amount* | *Pounds* | *Amount* | *Pounds* | *Amount* |
| Sept.—1st half ........ | 360,000 | $52,800 | 250,000 | $42,040 | 183,000 | $30,875 |
| Sept.—2d half ........ | 126,000 | 18,510 | 150,000 | 25,000 | 165,000 | 27,500 |
| Oct.—1st half ........ | 135,000 | 20,025 | 150,000 | 25,125 | 110,000 | 18,425 |
| Oct.—2d half ........ | 85,000 | 12,450 | 75,000 | 12,525 | 150,000 | 25,100 |

At October 31, 1947, there are 23,708 pounds of unconverted material on hand in the plant.

5 From the data below, prepare the following: [25]

*a* An account sales for September 1947, as rendered by each of the three consignees

*b* Columnar work sheet showing corrections to the accounts of the Winston Company, as of September 30, 1947 [No adjustment of the provision for income taxes is required.]

*c* An adjusted balance sheet of the Winston Company as of September 30, 1947

*d* A condensed income statement of the Winston Company for the year ended September 30, 1947

The Winston Company, which manufacturers and sells gas burners to be installed in coal-burning furnaces, arranged in September 1947, to sell some of its product through three dealers, to whom it consigned burners packed with their related parts and fixtures, each such package being identified as a burner.

The contract with the consignee provides that:

(1) He shall fix the sales price for all burners to be sold in his territory, such price to be approved by the Winston Company.

(2) He shall pay all expenses incident to handling, selling and collecting for the burners after delivery to him, except for repairs and expenses pertinent thereto, required because of defective production.

(3) He shall retain as commission 25% of the amount for which he sells the burners, exclusive of installation charges.

(4) He shall be responsible for the proper installation of burners sold and may make therefor suitable charges in which the Winston Company shall not participate.

(5) He shall render, within 10 days after the end of each month, an account sales accompanied by a check for the amount due the Winston Company as the result of transactions during the month to which the report relates.

A condensed trial balance of the Winston Company's accounts at September 30, 1947, follows:

| | *Debit* | *Credit* |
|---|---|---|
| Cash ........ | $ 58,910 | |
| Accounts receivable ........ | 241,964 | |
| Inventories | | |
| Finished burners and related parts and fixtures ........ | 21,200 | |
| Work in process, materials and supplies ........ | 42,271 | |
| Prepaid expenses ........ | 3,007 | |
| Plant ........ | 128,762 | |
| Accounts payable ........ | | $ 31,742 |
| Accrued liabilities ........ | | 138,798 |
| Capital stock ........ | | 100,000 |
| Earned surplus ........ | | 18,978 |
| Sales ........ | | 643,947 |
| Sales returns and allowances ........ | 2,648 | |
| Manufacturing ........ | 129,384 | |
| Selling expense ........ | 139,637 | |
| Administrative expense ........ | 89,423 | |
| Reserve for bad debts ........ | | 9,398 |
| Reserve for depreciation ........ | | 27,632 |
| Nonoperating income ........ | | 318 |
| Nonoperating expense ........ | 3,607 | |
| Provision for income taxes ........ | 110,000 | |
| | $970,813 | $970,813 |

All shipments charged to Accounts Receivable were credited to Sales.

Accounts receivable included accounts with the three consignees, which, upon examination, revealed the following:

### HOLMES PLUMBING COMPANY

| | | | |
|---|---|---|---|
| *Debits* | | | |
| Sept. 4, 1947 | 18 burners shipped on consignment | | $3,600.00 |
| Sept. 20, 1947 | Transportation charges paid on 2 burners returned as defective | | 22.00 |
| Sept. 27, 1947 | Cost of repairing 2 burners returned as defective | | 18.00 |
| | | | $3,640.00 |
| *Credits* | | | |
| Sept. 30, 1947 | Cash received for 13 burners | | 1,767.75 |
| Balance, Sept 30, 1947 | | | $1,872.25 |

### LUNDEEN HEATING EQUIPMENT COMPANY

| | | | |
|---|---|---|---|
| *Debits* | | | |
| Sept. 6, 1947 | 6 burners shipped on consignment | | $1,200.00 |
| Sept. 15, 1947 | Transportation charges on 1 burner returned as defective | | 28.00 |
| | | | $1,228.00 |
| *Credits* | | | |
| Sept. 15, 1947 | 1 burner returned as defective | $200.00 | |
| Sept. 30, 1947 | Cash received for 3 burners | 544.50 | |
| | | | 744.50 |
| Balance, Sept. 30, 1947 | | | $ 483.50 |

### QUINCY FURNACE COMPANY

| | | | |
|---|---|---|---|
| *Debits* | | | |
| Sept. 5, 1947 | 12 burners shipped on consignment | | $2,400.00 |
| Sept. 5, 1947 | Freight prepaid on consigned burners | | 36.00 |
| Sept. 30, 1947 | Commission on 9 burners | | 450.00 |
| | | | $2,886.00 |
| *Credits* | | | |
| Sept. 30, 1947 | Cash received for 9 burners | | 1,344.00 |
| Balance, Sept. 30, 1947 | | | $1,542.00 |

Consignees reported burners on hand at September 30, 1947, as follows:

| | |
|---|---|
| Holmes Plumbing Company | 3 |
| Lundeen Heating Equipment Company | 2 |
| Quincy Furnace Company | 3 |

Shipping records show that on September 27, 1947, the Winston Company shipped burners, freight prepaid, to replace those returned by consignees, as follows:

| | |
|---|---|
| To: Holmes Plumbing Company | 2 |
| Lundeen Heating Equipment Company | 1 |

Burners on hand at the Winston Company's plant at September 30, 1947, numbered 212 and were inventoried at manufacturing cost. Inventories at the beginning of the period have been closed into Manufacturing while those at the end of the period have been closed out of Manufacturing. All normal adjusting entries have been made for the fiscal year ended September 30, 1947. Unpaid commissions on sales were credited to Accrued Liabilities.

Account sales for September 1947, with related checks, were received by the Winston Company as follows:

| | |
|---|---|
| From: Holmes Plumbing Company | October 7, 1947 |
| Lundeen Heating Equipment Company | October 12, 1947 |
| Quincy Furnace Company | October 9, 1947 |

Those from Holmes Plumbing Company and Lundeen Heating Equipment Company reflect payments of $36 and $18 respectively for transportation charges which they paid upon receiving their consignments; that from Quincy Furnace Company includes a charge for the cost of repairs to a defective burner, in the amount of $6.

All entries in the Winston Company's accounts with the consignees which are dated September 30, 1947, were based on checks received and data recorded in their account sales received on the dates stated above.

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